Docket for 02-1196

(16)

No. 02-1196 Status: ARGUED
Title: Securities and Exchange Commission, Petitioner
v.
Charles E. Edwards
Docketed: February 14, 2003
Lower Ct: United States Court of Appeals for the Eleventh Circuit
Case Nos.: (01-10107)
Decision Date: August 6, 2002
Rehearing Denied: November 15, 2002

~~Date~~	~~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~
Feb 13 2003	Petition for writ of certiorari filed. (Response due March 17, 2003)
Mar 13 2003	Brief of respondent Charles E. Edwards in opposition filed.
Mar 17 2003	Motion for leave to file amicus brief filed by North American Securities Administrators Association, Inc.
Mar 17 2003	Motion for leave to file amicus brief filed by Florida Dept. of Financial Services, et al.
Mar 17 2003	Motion for leave to file amicus brief filed by Public Investors Arbitration Bar Association, Inc.
Mar 24 2003	Opposition of respondent to motions of all amici curiae for leave to file briefs as amicus curiae filed.
Mar 26 2003	Reply of petitioner Securities and Exchange Commision filed.
Apr 21 2003	Motion for leave to file amicus brief filed by North American Securities Administrators Association, Inc. GRANTED.
Apr 21 2003	Motion for leave to file amicus brief filed by Public Investors Arbitration Bar Association, Inc. GRANTED.
Apr 21 2003	Motion for leave to file amicus brief filed by Florida Dept. of Financial Services, et al. GRANTED.
Apr 21 2003	Petition GRANTED.
May 6 2003	Extension of time within which to file the joint appendix and petitioner's brief on the merits to and including June 26, 2003. Brief of respondent is due on or before August 7, 2003.
Jun 26 2003	Brief of petitioner Securities and Exchange Commision filed.
Jun 26 2003	Joint appendix filed.
Jun 26 2003	*Joint appendix in two volumes.
Jun 26 2003	Brief amicus curiae of AARP filed.
Jun 26 2003	Brief amicus curiae of North American Securities Administrators Association, Inc. filed.
Jun 26 2003	Brief amici curiae of Securities Regulators for Florida and Colorado filed.
Jun 26 2003	Brief amicus curiae of Public Investors Arbitration Bar Association, Inc. filed.
Aug 7 2003	Brief of respondent Charles E. Edwards filed.
Aug 19 2003	CIRCULATED.
Aug 19 2003	SET FOR ARGUMENT Tuesday November 4, 2003.
Aug 29 2003	Application (03A187) to extend the time to file a reply brief from September 7, 2003 to September 18, 2003, submitted to Justice Kennedy.
Sep 2 2003	Application (03A187) granted by Justice Kennedy extending the time to file until September 18, 2003.

Sep 4 2003	Letter regarding joint appendix of the Securities and Exchange Commision filed.
Sep 9 2003	Record received from the U.S.C.A. for the 11th Circuit. (1 box) *A portion of this record is sealed.
Sep 9 2003	Record received from the U.S.D.C. for the Northern Dist. of Georgia. (1 box)
Sep 17 2003	Reply of petitioner Securities and Exchange Commision filed.
Oct 29 2003	Motion for leave to file amicus brief out-of-time filed by Financial World Companies, Inc.
Nov 4 2003	Argued. For Petitioner: Theodore B. Olson, Solicitor General, Department of Justice, Washington, DC. For Respondent: Michael K. Wolensky.
Dec 1 2003	Motion for leave to file amicus brief filed by Financial World Companies, Inc. DENIED.

Supreme Court, U.S.
FILED

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No.

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definitions of "security" in Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

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In the Supreme Court of the United States

No.

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Securities and Exchange Commission (SEC or Commission), respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-15a) is reported at 300 F.3d 1281. The order of the district court (App., *infra*, 16a-27a) granting the Commission's motion for a preliminary injunction is reported at 123 F. Supp. 2d 1349.

JURISDICTION

The judgment of the court of appeals was entered on August 6, 2002. A petition for rehearing was denied on

November 15, 2002 (App., *infra*, 28a-29a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The texts of 15 U.S.C. 77b(a)(1) and 78c(a)(10) are reproduced in Appendix D, *infra*, 30a-31a.

STATEMENT

1. The definitions of "security" in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10), include not only conventional securities, such as "stock[s]" and "bond[s]," but also the broader term "investment contract." The Court explained in *Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990), that, because "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called," Congress crafted "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."

In keeping with that broad definition, the Court has held that an "investment contract" means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946) (*Howey*). The Court has stressed that the term "investment contract" "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. Accord *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (*Joiner*).

2. Respondent Charles E. Edwards was the founder, chairman, chief executive officer and sole owner of ETS Payphones, Inc. (ETS). App., *infra*, 2a; Exh. 20, at 25, 31; 10/12/00 Tr. 17, 58. In order to obtain financing from the public to operate its business, ETS, under respondent's direction, offered and sold interests consisting of a payphone, a leaseback/management agreement, and a buyback agreement. App., *infra*, 2a-3a, 17a; Exh. 18, at 5-8; Exh. 20, at 33-35. Specifically, investors bought payphones for up to $7000 each from an ETS subsidiary and leased them back to ETS for five years for fixed payments of $82 per month per phone (approximately a 14% return) regardless of the profitability of the phone. App., *infra*, 17a-18a; Exh. 14; Exh. 18, at 5-6. As part of the lease agreement, ETS promised to refund the full purchase price of each payphone at the end of the lease or within 180 days of the investor's request. App., *infra*, 17a; Exh. 14; Exh. 15, at 11. ETS chose the locations for the payphones and managed and maintained them; investors never saw the phones and often did not know where they were located. App., *infra*, 17a, 22a; Exh. 20, at 94-95.

ETS marketed its payphone investments over the internet and through a network of independent distributors. App., *infra*, 17a; Exh. 20, at 42-48. Promotional brochures and materials on the web sites portrayed the company and its management as experienced and successful in the telecommunications industry, touted the profitability of the payphone industry, and exhorted prospective investors to "watch the profits add up." App., *infra*, 17a-18a; Exh. 15, at 9; Exh. 17, at 8. The ETS program was described as "virtually recession-proof," providing a "steady, immediate cash flow," easily liquidated, and suitable for retirement accounts. Exh. 15, at 5, 8, 12; Exh. 17, at 5. As a result of that

marketing, ETS took in approximately $300 million from more than 10,000 investors in 38 States. See App., *infra*, 3a; Compl. 1.

Although the sales literature and web sites presented ETS as a profitable company, in fact, the opposite was true: ETS was never profitable. App., *infra*, 18a, 24a; Exh. 1, at 4-6. Because revenue from payphone operations fell short of the amount needed to meet rental payments to investors, ETS used funds from new investors to pay existing investors. App., *infra*, 18a, 24a; Exh. 1, at 6; 10/12/00 Tr. 41. ETS had an operating loss of more than $42 million in 1999 and more than $33 million for the first six months of 2000. Exh. 1, at 4; 10/12/00 Tr. 39-40. In September 2000, ETS filed for bankruptcy protection. App., *infra*, 19a.

Respondent was aware of the financial condition of ETS, including the fact that the company was dependent on funds from new investors to sustain its operations. App., *infra*, 19a, 25a; 10/12/00 Tr. 59-60. Respondent nonetheless failed to disclose to investors ETS's true financial condition; nor did he disclose that the company could not honor its commitment to repurchase investors' phones if a significant number of them exercised their buyback option. Exh. 6, at 2; 10/12/00 Tr. 59-60. Indeed, in a communication as late as July 2000, only two months before the bankruptcy filing, he reassured investors of ETS's financial stability and asserted that the company made a profit of nearly $9 million in 1999. Exh. 23, at 2; see App., *infra*, 25a ("Despite [his] knowledge, [respondent] marketed the program as a profitable enterprise 'ringing with opportunity.'").

Despite ETS's consistent losses, respondent personally profited. App., *infra*, 18a. Respondent drained approximately $18 million from the company in direct compensation, management fees, and interest-free

loans to other companies he controlled. *Ibid.*; 10/12/00 Tr. 44-45, 64-65, 68-69.

3. In September 2000, the SEC brought this civil law enforcement action against respondent and ETS in the United States District Court for the Northern District of Georgia. The SEC alleged that, by carrying out the payphone investment scheme, respondent and ETS violated the registration requirements of Section 5(a) and (c) of the Securities Act, 15 U.S.C. 77e(a) and (c), and the antifraud provisions of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Compl. 9-12. The Commission sought a permanent injunction against future violations of the registration and antifraud provisions, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties. *Id.* at 12-16.[1]

The Commission moved at the outset of the case for preliminary relief. Following an evidentiary hearing, the district court found that the SEC had made a prima facie showing that respondent had committed the alleged violations, and the court granted the Commission's request for preliminary relief against him. App., *infra*, 16a-27a.[2]

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[1] The registration provisions of the Securities Act require the filing of a registration statement, and the delivery to investors of a prospectus, containing information about the company, including financial statements. See 15 U.S.C. 77f, 77g(a), 77j, and Schedule A, Items 25 and 26. The registration provisions are enforceable both by the government and through private actions. See 15 U.S.C. 77t, 77*l*(a)(1).

[2] ETS itself, without admitting or denying the allegations of the Commission's complaint, consented to a preliminary injunction. App., *infra*, 16a. ETS later consented to a permanent injunction.

The district court found that the payphone sale/leaseback/buyback arrangement was an "investment contract" under the federal securities laws. App., *infra*, 17a-23a. The court applied the test for an investment contract set forth in *Howey*, 328 U.S. at 298-299, which the Eleventh Circuit has characterized as having three elements: "(1) an investment of money; (2) a common enterprise; and (3) the expectation of profits to be derived solely from the efforts of others." App., *infra*, 19a (quoting *Villeneuve* v. *Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (1983), aff'd en banc, 730 F.2d 1403 (11th Cir. 1984)). The district court found that participants in the scheme had made "an investment of money." *Ibid.* The court also found a "common enterprise," because recovery of the investments "depend[ed] upon the financial viability of [ETS] and [its] ability to generate a profit." *Id.* at 21a. Finally, the court found that the investors expected profits from ETS's efforts rather than their own, because they had relinquished "all responsibility for the payphones" to respondent and ETS, who "monitored, managed, and maintained" the phones. *Id.* at 22a.

After determining that the payphone arrangement was an investment contract, the district court concluded that the SEC had established a prima facie case that respondent violated the registration requirements of the Securities Act by selling "unregistered securities to thousands of people in thirty-eight states." App., *infra*, 23a. The district court also found that the SEC had established a prima facie case that respondent committed fraud in connection with the sale of securities because "investors were led to believe that both ETS

SEC v. *ETS Payphones, Inc.*, No. 00-CV-2532 (N.D. Ga. entered Jan. 14, 2002) (Docket Entry No. 157).

and its payphone program generated a profit" while "ETS had failed to make a profit," "was losing money on its payphone program," and "depended on funds from new investors in order to sustain operations." *Id.* at 24a. Concluding that the SEC was likely to succeed on the merits, the court entered a preliminary injunction against future violations of the registration and antifraud provisions of the securities laws and froze respondent's assets to the extent that they were not subject to the bankruptcy proceedings involving ETS and its subsidiaries. *Id.* at 26a-27a.

4. In a per curiam opinion, the United States Court of Appeals for the Eleventh Circuit reversed the district court's judgment and ordered the dismissal of the SEC's complaint for lack of subject matter jurisdiction under the federal securities laws. App., *infra*, 1a-15a. The court of appeals held that the payphone sale/leaseback/buyback scheme did not involve an "investment contract." *Id.* at 4a-8a.

The court acknowledged that "an investment of money is apparent" in the scheme (App., *infra*, 5a) and that ETS investors purchased the payphone packages "for the purpose of earning a return on the purchase price" (*id.* at 6a). The court concluded, however, that the SEC could not show "that investors who contracted with ETS expected profits to be derived solely through the efforts of others." *Ibid.*

The court understood the decision in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975), to have limited the scope of "profits" under *Howey* to "capital appreciation" or "a participation in earnings" of the enterprise. App., *infra*, 6a. The court of appeals held that the monthly payments that ETS investors received were not a participation in ETS's earnings be-

cause they were "fixed" amounts, rather than amounts that varied according to the earnings of ETS. *Id.* at 7a.

The court of appeals also held that, even if the monthly payments could be considered profits, they were not "derived solely from the efforts of others." App., *infra*, 7a. The court reasoned that "the determining factor is the fact that investors were entitled to their lease payments under their contracts with ETS." *Id.* at 8a. Because their returns were thus "contractually guaranteed," the court held, "those returns were not derived from the efforts of [respondent] or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract." *Ibid.*

Because the court of appeals concluded that investors in the ETS payphone scheme did not expect profits derived from the efforts of others, the court found it unnecessary to determine whether there was a "common enterprise" as described in *Howey*. App., *infra*, 5a-6a. Judge Lay, however, filed a concurring opinion addressing that issue. *Id.* at 9a-15a.

The court of appeals subsequently denied the SEC's petition for rehearing and rehearing en banc. App., *infra*, 28a-29a.

REASONS FOR GRANTING THE PETITION

This case involves a nationwide fraudulent scheme that promised investors a high rate of return on their money with no effort on their part. The constricted interpretation of the term "investment contract" adopted by the court of appeals erroneously excludes those investors from the protections of the Securities Act and the Exchange Act and opens a seemingly limitless gap in the protection that those Acts provide against securities fraud. An investment is not precluded from being an "investment contract" because the promised

return is fixed rather than variable or because the return is "contractually guaranteed." The contrary decision of the court of appeals is a significant and unwarranted departure from the flexible definition of "investment contract" that this Court has consistently applied in *Howey*, *Joiner*, and other cases, based on the broad language of the Acts and the congressional intent manifested by that language. The decision of the court of appeals conflicts with decisions of at least two other courts of appeals: *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), and *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978). The court of appeals' decision also conflicts with the interpretation of the federal securities laws reflected in formal adjudicatory opinions and other statements of the SEC. If allowed to stand, the decision will significantly impair the Commission's ability to enforce the securities laws for the protection of investors. This Court's review is therefore warranted.

1. The court of appeals erred in holding that an investment cannot be an "investment contract" if the return is fixed rather than variable or if the investor is contractually entitled to a particular amount or rate of return. Those restrictions are unsupported by the text of the securities laws, undermine Congress's goal of comprehensive protection for investors, and depart from the flexible definition of "investment contract" consistently applied by this Court.

a. As this Court has repeatedly stressed, the text of the federal securities laws defines "security" in the broadest terms. See 15 U.S.C. 77b(a)(1), 78c(a)(10) (reproduced at App., *infra*, 30a-31a). "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61.

Congress determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Forman*, 421 U.S. at 847-848 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)).

In order to craft "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment," *Reves*, 494 U.S. at 61, Congress included in the definition not just "standardized" instruments, such as stocks and bonds, but also "investment contracts." *Joiner*, 320 U.S. at 351. Congress included that "general descriptive designation[]" to ensure the comprehensiveness of the Acts' coverage, which "does not stop with the obvious and commonplace" but includes "[n]ovel, uncommon, or irregular devices" that are offered as investments. *Ibid.*

Nothing in the term "investment contract" suggests that the term is limited to an arrangement promising a variable return or a return that is not "contractually guaranteed" (*i.e.*, not specified or promised as an entitlement in a contract).[3] Invest means "to lay out

[3] A true "guaranty" is a promise by a third party to pay the debt or otherwise perform the obligation of the principal promisor in the event of nonpayment or other nonperformance by the principal promisor. See *Black's Law Dictionary* 634 (5th ed. 1979). There was no such "guaranty" here (although, even if there were, that would not mean the arrangement was not an investment contract). The court of appeals used the term "contractually guaranteed" more loosely, as a shorthand description of the fact, recited in the preceding sentence, that "investors were entitled to their lease payments under their contracts with ETS." App., *infra*, 8a. Thus, the court apparently used the term merely to indicate that

(money or capital) in business with the view to obtaining an income or profit," and investment is the "investing of money or capital in some species of property for income or profit." *Webster's New International Dictionary* 1306 (1934); see *Webster's Third New International Dictionary* 1190 (1993) ("an expenditure of money for income or profit or to purchase something of intrinsic value"). Neither "income" nor "profit" necessarily connotes a variable (rather than fixed) return or a return that is not promised by contract. See *Webster's New International Dictionary*, *supra*, at 1258, 1976; *Webster's Third New International Dictionary*, *supra*, at 1143, 1811. Moreover, a contract is "[a]n agreement between two or more persons to do or forbear something." *Webster's New International Dictionary*, *supra*, at 578; accord *Webster's Third New International Dictionary*, *supra*, at 494. Thus, the very term "investment contract" itself contradicts any notion that instruments of that name cannot include investments in which the return is promised by one party to the contract.

Further, as this Court noted in *Howey*, the term "investment contract" had a well-established meaning under cases construing the state Blue Sky laws that predated the federal securities laws. 328 U.S. at 298. State cases established that an investment contract meant "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'" *Ibid.* (quoting *State* v. *Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920)). That definition, which includes both

the amount or rate of return was specified or otherwise expressly promised in the contract. This brief uses the term in the same sense as the court of appeals.

"income" and "profit" and was "broadly construed by state courts so as to afford the investing public a full measure of protection" (328 U.S. at 298), is clearly expansive enough to include an investment having a fixed or guaranteed return. Indeed, two of the state cases cited by this Court in *Howey* to illustrate the meaning of "investment contract" involved fixed or contractually guaranteed returns. See *People* v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) (return of $7500 on investment of $5000); *Stevens* v. *Liberty Packing Corp.*, 161 A. 193, 195 (N.J. Ch. 1932) ("guaranteed" return amounting to $56 per year on investment of $175).

The role of the term "investment contract" in the statutory definitions of security confirms that the term includes an agreement providing for a fixed or guaranteed return. Congress included the term "investment contract" as a catch-all for unusual investments that cannot be categorized as one of the standardized instruments included in the definitions. See p. 10, *supra*; *Golden* v. *Garfalo*, 678 F.2d 1139, 1144 (2d Cir. 1982). Several of the conventional instruments enumerated in the definitions of security are debt securities that traditionally yield a fixed return, *e.g.*, "bond" and "debenture," 15 U.S.C. 77b(a)(1), 78c(a)(10), and that return is typically promised ("guaranteed") in the instrument itself. Moreover, the definition of security in the 1933 Act expressly includes a "guarantee of" any of the other enumerated items. 15 U.S.C. 77b(a)(1). Because the specific securities listed in the definitions of security include investments having returns that are fixed and contractually guaranteed, it makes sense that the catch-all term "investment contract" should also include such investments. See *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (purpose of

"the term 'investment contract'" is to identify "unconventional instruments that have the essential properties of a debt or equity security").

By excluding investments with fixed or contractually promised returns from the catch-all category of "investment contract," the court of appeals' decision opens an immense loophole in the definition of security. A promoter who seeks to obtain capital to operate a business enterprise could avoid the coverage of the securities laws simply by offering contracts that promise a fixed or specified return rather than provide more generally for a return that varies with the earnings of the enterprise. Those who perpetrate fraudulent investment schemes frequently promise fixed or guaranteed returns, and such promises are particularly attractive to the elderly or unsophisticated investors most likely to fall victim to such fraud. The large gap in the coverage of the securities' laws that results from the court of appeals' decision therefore frustrates Congress's goal of ensuring comprehensive protection for investors by "regulat[ing] *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61. Because investments include interests yielding fixed and contractually promised returns, it makes no sense to exclude such interests from the scope of "investment contract."

b. In engrafting rigid, technical limits onto the broad language used by Congress, the court of appeals also departed from the flexible definition of "investment contract" consistently applied by this Court. In *Howey*, the Court adopted the broad definition of "investment contract" under the state Blue Sky laws, which the Court paraphrased as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from

the efforts of the promoter or a third party." *Howey*, 328 U.S. at 298-299. The Court noted that this definition is "flexible" and "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. The Court stressed that, in applying the definition, the emphasis is on "economic reality" and the substance of the transaction rather than its form. *Id.* at 298. The Court further cautioned that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301.

Applying that flexible approach, the Court in *Howey* concluded that the investments at issue—fee simple interests in orange groves packaged with service contracts to cultivate the land, sell the fruit for the investor, and remit to him any profit—were investment contracts. 328 U.S. at 300. The Court cited (*id.* at 299 n.5) a variety of cases, including a formal adjudication by the Commission, in which "transactions which, in form, appear to involve nothing more than the sale of real estate, chattels, or services, have been held to be investment contracts where, in substance, they involve the laying out of money by the investor on the assumption and expectation that the investment will return a profit without any active effort on his part." *In re Natural Res. Corp.*, 8 S.E.C. 635 (1941). The Court explained that it is "immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise" (*Howey*, 328 U.S. at 299), even if the "tangible interest which is sold has intrinsic

value independent of the success of the enterprise as a whole" (*id.* at 301).[4]

In concluding that the orange grove scheme involved an investment contract, the Court in *Howey* relied on the fact that investors did not expect to use the land themselves but were "attracted solely by the prospects of a *return* on their investment" (328 U.S. at 300 (emphasis added)), but the Court did not concern itself with whether the anticipated return was fixed or variable, contractually promised or unspecified. On the contrary, the Court stated that, in determining whether an investment contract is involved, "it is immaterial whether the enterprise is speculative or non-speculative." *Id.* at 301.

Although the definition that the Court adopted used the term "profits," as noted above, that term is not limited to variable or unspecified returns. Rather, the Court made clear that the term "investment contract" in the federal securities laws was intended to have the same meaning that it had been given under the state Blue Sky laws, which used the even broader phrase

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[4] In the half century since *Howey*, the courts of appeals have continued to find such schemes to be investment contracts. See *Blackwell* v. *Bentsen*, 203 F.2d 690 (5th Cir. 1953) (citrus groves), cert. dismissed, 347 U.S. 925 (1954); *Continental Mktg. Corp.* v. *SEC*, 387 F.2d 466 (10th Cir. 1967) (beavers), cert. denied, 391 U.S. 905 (1968); *Kemmerer* v. *Weaver*, 445 F.2d 76 (7th Cir. 1971) (beavers); *Glen-Arden Commodities, Inc.* v. *Costantino*, 493 F.2d 1027 (2d Cir. 1974) (whiskey); *Miller* v. *Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (chinchillas); *Smith* v. *Gross*, 604 F.2d 639 (9th Cir. 1979) (earthworms); *United States* v. *Jones*, 712 F.2d 1316, 1321-1322 (9th Cir.) (truck trailers), cert. denied, 464 U.S. 986 (1983); *Albanese* v. *Florida Nat'l Bank*, 823 F.2d 408 (11th Cir. 1987) (ice machines); *Long* v. *Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989) (cattle); *Bailey* v. *J.W.K. Prop., Inc.*, 904 F.2d 918 (4th Cir. 1990) (cow embryos).

"income or profit." See p. 11, *supra*. And the Court cited with approval not only the two state cases involving fixed or guaranteed returns described above, but also an SEC injunctive action in which the investment contract promised a fixed return. See *Howey*, 328 U.S. at 299 n.5 (citing *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232, 237-238 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940)). Thus, the ETS scheme fits squarely within *Howey*'s understanding of an investment contract.

The Court also took a flexible approach to the definition of "investment contract" in *Joiner*. There the Court held that assignments of oil leases, sold in a nationwide campaign that promoted them as investments and "assured [potential investors] that the Joiner Company was engaged in and would complete the drilling of a test well * * * to test the oil-producing possibilities of the offered leaseholds," were securities in the form of investment contracts. 320 U.S. at 346. The Court reasoned that whether an investment contract is involved turns on "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-353. "In the enforcement of an act such as this," the Court stressed, "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." *Id.* at 353. The Court took the same approach in *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), which held that investments in certain annuity products that were promoted as a means of achieving financial "'growth' through sound investment management" were investment contracts. *Id.* at 211.

Viewed in light of the promoter's representations, as in *Joiner* and *United Benefit*, the ETS arrangement is

plainly an investment contract. Respondent consistently marketed the ETS arrangement as an "investment" opportunity that would provide "profits." See App., *infra*, 17a-18a; Exh. 14, at 1, 2; Exh. 15, at 5, 7, 8, 9; Exh. 17, at 4, 5, 8, 9, 10, 11; Exh. 22, at 1, 5. The lure that ETS' promotional materials held out to prospective investors—the expectation of a high return on their money from a profitable company in a profitable industry, with no effort expended by the investors themselves—readily fits within the *Howey* definition of investment contract.[5]

c. The court of appeals mistakenly concluded (App., *infra*, 6a-7a) that the scope of the "profits" component of the *Howey* definition had been narrowed by a statement in this Court's decision in *Forman*. In *Forman*, the Court, in describing its holdings in prior investment contract cases, stated: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment * * * or a participation in earnings resulting from the use of investors' funds." 421 U.S. at 852. Contrary to the interpretation of the court of appeals, *Forman*'s reference to "a participation in earnings" did not create a new test that

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[5] The Court has consistently followed the flexible approach illustrated by *Howey*, *Joiner*, and *United Benefit* in its other cases involving investment contracts. See *Marine Bank* v. *Weaver*, 455 U.S. 551, 555-556 (1982) (noting breadth of definition); *id.* at 556 (noting importance of how instrument is promoted); *Forman*, 421 U.S. at 848 (emphasizing importance of economic reality and substance rather than form); *id.* at 852 (stating that investment contract definition "embodies the essential attributes that run through all of the Court's decisions defining a security"); *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967) (emphasizing substance and economic reality rather than form); *id.* at 338 (reiterating that definition is "flexible" and "capable of adaptation").

narrowed *Howey* to variable return investments. The Court in *Forman* was simply describing one of its prior cases (*Tcherepnin* v. *Knight*, 389 U.S. 332 (1967)), and did not thereby hold that no other kind of return can constitute profits.

The basic point of the Court's reference in *Forman* to capital appreciation or a participation in earnings was to distinguish the situation in which an investor is "'attracted only by the prospects of a return' on his investment," which involves a security, from a situation in which "a purchaser is motivated by a desire to use or consume the item purchased," which does not involve a security. 421 U.S. at 852-853. Thus, in *Forman*, in which the Court held that stock entitling low-income purchasers to lease an apartment in a state-subsidized and supervised non-profit housing cooperative was not an "investment contract," the Court concluded that the purchasers "were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." *Id.* at 853. In this case, there is no question that investors in the ETS scheme were motivated by the prospect of a financial return rather than the desire for personal use of the telephones involved in the scheme.

Moreover, the Court made clear in *Forman* that "profit may be derived from the *income* yielded by an investment," 421 U.S. at 855 (emphasis added), and that the essence of the test is whether "the investor is 'attracted solely by the prospects of a *return*' on his investment," *id.* at 852 (emphasis added). The terms "income" and "return" are not limited to variable yields. See p. 11, *supra*; *Webster's New International Dictionary*, *supra*, at 2130; *Webster's Third New International Dictionary*, *supra*, at 1941. Nor is "a participation in earnings" limited to variable return investments. An

investor can have a "participation" in the "earnings" of an enterprise even when his return is not *measured* by those earnings. Irrespective of the *measure* of the return, an investor expects a "participation" in "earnings" when, as in this case, he is led to expect that the *source* of his return will be the company's earnings. Cf. *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) (describing fixed payments promised to investors for bringing in new investors as "a share in the proceeds" of the business).[6]

d. Nor is there anything in this Court's cases that supports the court of appeals' conclusion that profits that are "contractually guaranteed"—*i.e.*, expressed as an entitlement under a contract (App., *infra*, 8a)—are not expected to come "from the efforts of the promoter or a third party" (*Howey*, 328 U.S. at 299). Under *Howey*, the focus of the "efforts" element is not on whether profits are promised in the contract, but on whether the promoter, rather than the investors,

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[6] The *Howey* definition of investment contract also was not narrowed by this Court's characterization in *Reves* of the statement that the Court made in *Forman*. In *Reves*, the Court established the test for determining whether an interest denominated as a note is a security. In so doing, the Court concluded that the *Howey* test does not govern that question, and the Court stated that "the *Howey* test is irrelevant to the issue before us today." 494 U.S. at 64, 62 n.4. In describing the "irrelevant" *Howey* test, however, the Court (relying on *Forman*) stated that "profit," as used in that test, had been defined "restrictively" so that "a rate of interest not keyed to the earnings of the enterprise" would not constitute "profit." *Id.* at 68 n.4. The meaning of the *Howey* test was not, however, before the Court in *Reves*, and the Court therefore had no occasion to (and did not purport to) alter its meaning. The Court merely characterized how it believed *Forman* had interpreted the *Howey* test. As the discussion above illustrates, the Court's characterization of *Forman* (and *Howey*) was mistaken.

manages the enterprise that is expected to generate the profits. See 328 U.S. at 300 ("manage[ment] by [the promoters] or third parties with adequate personnel and equipment [was] essential if the investors [we]re to achieve their paramount aim of a return on their investments"). Here, the district court found that respondent "manage[d], maintain[ed], and operate[d] the pay phones" and that "investors retain[ed] little, if any, control." App., *infra*, 17a. The court of appeals did not conclude that that finding was clearly erroneous. Indeed, the court recognized that "the funds generated by the payphones helped ETS meet its [lease and buyback] obligations." *Id.* at 7a. Thus, the court erred in focusing on the fact that the investors' income or return was promised in the contracts, rather than on the fact that investors expected to receive their returns from the earnings generated by respondent's efforts in managing ETS.[7]

2. This Court's review of the erroneous decision of the court of appeals is warranted because the decision conflicts with decisions of at least two other courts of appeals. In *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (2000), cert. denied, 532 U.S. 905 (2001), the Third Circuit expressly rejected the argument that the promise of a fixed return precludes an interest or arrangement

[7] Even if the court of appeals had been correct in its narrow interpretation of the term "investment contract," it still would have erred by ordering the dismissal of the Commission's complaint for lack of subject matter jurisdiction under the securities laws. The Commission argued in the district court that the investment instruments here also qualified as securities because they were "notes" or "evidences of indebtedness," and the court of appeals should have remanded for the district court to consider whether the case could proceed on one of those theories or any other theory.

from being an investment contract. Purchasers of Infinity's "property transfer contracts" transferred money to a trust to invest at the trustees' discretion. *Id.* at 184. As in the present case, participants were by "contract[]" "guaranteed" (*id.* at 187) a high, fixed rate of return (either 138% or 181%, depending on the amount invested) and repayment upon demand (*id.* at 184-185 & n.2). The *Infinity* defendants raised $26.6 million from 10,000 investors nationwide, but invested only $12 million of it, made no profits on the funds invested, and used the remainder of the funds for themselves. *Id.* at 185. Like respondent, the defendants in *Infinity* failed to disclose the enterprise's mounting losses or that they were using incoming funds from new investors to pay returns on earlier investors' funds. *Ibid.*

Notwithstanding the fixed and contractually guaranteed return, the Third Circuit held that the property transfer contracts "clearly constitute securities." 212 F.3d at 191. The court explained that

> the definition of security does not turn on whether the investor receives a variable or fixed rate of return. * * * The mere fact that the expected rate of return is not speculative does not, by itself, establish that the property transfer contracts here are not "investment contracts" within the meaning of [the] federal securities laws.

Id. at 189. The court concluded: "We will not embroider a loophole into the fabric of the securities laws by limiting the definition of 'securities' in a manner that unduly circumscribes the protection Congress intended to extend to investors." *Id.* at 191.

Similarly, in *United States* v. *Carman*, 577 F.2d 556 (1978), the Ninth Circuit held that an investment with a

fixed return and a true guaranty was an investment contract. The defendant in *Carman* sold a different asset than respondent—a federally insured student promissory note rather than a payphone—but, like respondent, he packaged that asset with a service contract and a repurchase agreement. *Id.* at 560. The *Carman* court held that "[t]he combination created * * * an integrated investment package which must be viewed in its entirety in determining whether it is within or without the Act." *Id.* at 564 (internal quotation marks and citation omitted). The court rejected the defendant's argument that the package could not be an investment contract "because the return was in the form of fixed interest, guaranteed by the federal government." *Id.* at 563. The court recognized that, despite the fixed return and federal guaranty, purchasers of the note packages remained subject to investment risk. The federal guaranty was conditioned on the defendant's "care and diligence" in "making and collecting on the notes." *Ibid.* Investors were therefore dependent on the defendant's sound management and continued solvency without which it would not be able to meet its obligations (*ibid.*), just as the investors in this case were dependent on ETS's continued solvency for ETS to be able to meet its lease-payment and repurchase obligations. The *Carman* court concluded that "this risk of loss is sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed." *Ibid.*

Other courts of appeals have also found instruments or schemes yielding a fixed or contractually guaranteed return to be investment contracts, albeit without directly addressing the arguments adopted by the court of appeals here. See, *e.g.*, *SEC* v. *SG Ltd.*, 265 F.3d 42, 51 (1st Cir. 2001) ("flat 10% guaranteed return"); *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 234 n.2 (2d Cir. 1985) (certificates of deposit paying fixed rates of between 12.55% and 14.60%); *SEC* v. *Professional Assocs.*, 731 F.2d 349, 351, 355, 357 (6th Cir. 1984) (units in escrow account earning "interest" and trust accounts paying 9% annually); *SEC* v. *Better Life Club of Am., Inc.*, 995 F. Supp. 167, 173-174 (D.D.C. 1998) (holding that purported "loans" promising fixed return to investor-lenders (double the money invested) were investment contracts), aff'd, 203 F.3d 54 (D.C. Cir.) (Table), cert. denied, 528 U.S. 867 (1999). See also *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940). The results in those cases cannot be reconciled with the holding of the court of appeals in this case.

3. Review by this Court is also warranted because the Eleventh Circuit's decision conflicts with the SEC's longstanding interpretation of the securities laws, and, if allowed to stand, will significantly impair the Commission's ability to enforce those laws for the protection of investors. The SEC's view that an investment contract can include a fixed or contractually guaranteed return is embodied in at least two formal adjudications. In *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), *available in* 1969 WL 95369, the Commission ruled that mortgage notes—which provide a fixed rate of interest as the return—were investment contracts when they were sold together with management services and a promise to repurchase the notes in the event of default. The Commission noted that the sales literature stressed "the 'guarantee' of the notes by" the company and concluded that the purchasers were "rel[ying] upon the services and undertakings of others to secure the return of a profit." 1969 WL 95359, at *3-*4. Similarly,

in *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), *available in* 1982 WL 522493, the SEC held that promissory notes secured by deeds of trust on real property and sold with a package of management services were investment contracts. The Commission noted that the advertisements to potential investors stated "that investors will receive a specified percentage return on their investment depending upon the market at the time the loan is made" and that "[t]he return currently being offered is about 16 percent." 1982 WL 522493, at *2. The SEC's interpretation of the securities laws in those adjudications is entitled to deference under *Chevron U.S.A. Inc* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). See *SEC* v. *Zandford*, 122 S. Ct. 1899, 1903 (2002) (citing *United States* v. *Mead Corp.*, 533 U.S. 218, 229-230 & n.12 (2001)).

The SEC has also taken the position in its briefs before this Court and in other official statements that "investment contracts" may offer fixed or contractually guaranteed returns. See, *e.g.*, Br. for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480); *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, SEC Release No. 33-3892 (Jan. 31, 1958) (noting that an "[i]mplied or actual guarantee of specified yield or return" is indicative of an investment contract); *Multi-level Distributorships and Pyramid Sales Plans*, SEC Release Nos. 33-5211 & 34-9387 (Dec. 7, 1971) (stating that it is not "significant that the return promised for use of an investor's money may be something other than a share of the profits of the enterprise").

The SEC's position that an investment contract can include a fixed and contractually guaranteed return is

also reflected in numerous civil enforcement actions, including one prosecuted as early as 1936. In *SEC* v. *Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940), the SEC brought a civil enforcement action for violations of the 1933 Act against various individuals, an association, and a corporation that sold investment contracts promising that, after five years, investors would receive their initial principal plus a 30% per annum return. See *e.g.*, *Los Angeles Trust, Deed & Mortgage Exch.* v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961).

The Commission continues to bring many injunctive and administrative actions each year in which the schemes involve investment contracts promising fixed or guaranteed returns, including pay telephone sale/leaseback schemes like the one in this case. See, *e.g.*, *SEC* v. *Amtel Communications, Inc.*, 60 S.E.C. Dkt. 2080 (Nov. 7, 1995) ($51 per month lease payment). In fiscal year 2002 alone, the SEC instituted more than two dozen actions involving investment contracts offering fixed and contractually guaranteed returns. See, *e.g.*, *SEC* v. *Americash-Inc.com*, No. 02-80457 (S.D. Fla. compl. filed May 16, 2002) ("guaranteed" 36% return); *SEC* v. *U.S. Funding Corp.*, No. 2:02cv2089 (D.N.J. compl. filed May 2, 2002) ("guaranteed" return of 20% for one-year investment and 25% for two-year investment); *SEC* v. *Dunbar*, No. 02-233 (M.D. La. compl. filed Mar. 4, 2002) (return of $100,000 on investment of $200); *SEC* v. *CDH & Affiliates, Inc.*, No. 3:02cv00017 (N.D. Ga. compl. filed Feb. 25, 2002) (return of 30-40% every ten days); *SEC* v. *Texon Energy Corp.*, No. 2:01cv09706 (C.D. Cal. compl. filed Nov. 13, 2001) (return of 12% per year).

There would be a serious gap in investor protection if the court of appeals' decision were allowed to stand and were followed by other courts, thus precluding the Commission from bringing such enforcement actions. As explained above, the phrase "investment contract" was included in the statutory definition of a security as a catch-all for investments that do not fit easily into the other categories listed. The "investment contract" category has served as a critical means of bringing a host of unconventional financial arrangements—offering both fixed and variable returns—within the purview of the federal securities laws. See cases cited at pp. 12, 14-15 n.4, 20-25, *supra*. Excluding such unconventional investments from the scope of the securities laws because they offer a fixed return or are "contractually guaranteed" would be a radical departure from the enforcement history under the Act and would significantly impair the Commission's ability to protect investors from securities fraud. Indeed, the court of appeals' decision provides a recipe for unscrupulous promoters to circumvent the securities laws by describing the returns offered by their investment schemes as fixed or contractually guaranteed amounts.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 2003

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-10107

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

ETS PAYPHONES, INC., DEFENDANT,
CHARLES E. EDWARDS, DEFENDANT-APPELLANT

Filed: Aug. 6, 2002

Appeal from the United States District Court for the Northern District of Georgia.

Before: EDMONDSON, Chief Judge, and HILL and LAY,* Circuit Judges.

PER CURIAM:

Charles E. Edwards appeals from the district court's grant of a preliminary injunction in favor of the Securities and Exchange Commission (SEC). The SEC alleged Edwards' company, ETS Payphones, Inc. (ETS), sold securities in violation of the registration and anti-fraud provisions of the federal securities laws. *See* 15 U.S.C. §§ 77e(a), 77e(c), 77q(a), 78j(b); 17 C.F.R. § 240.10b-5. The SEC alleged these securities involved

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* Honorable Donald P. Lay, U.S. Circuit Judge for the Eighth Circuit, sitting by designation.

"investment contracts" whereby investors purchased a pay telephone from Edwards only to lease it back to ETS for management in exchange for a fixed monthly fee. The court determined it had jurisdiction over the SEC's action and preliminarily enjoined Edwards from future violations of the securities laws. It also froze Edwards' assets in anticipation of possible future disgorgement. On appeal, Edwards urges that the transactions did not involve securities and that the SEC lacks subject matter jurisdiction. We agree.

Facts

Edwards is the principal actor in several business entities relevant to this appeal. He is the founder and majority stockholder of ETS. He is a member of its board of directors and served as its chief executive officer for most of the time period relevant to this appeal. ETS was incorporated to provide management services, i.e. placement, advertising, maintenance, coin collecting, and accounting, for owners of pay telephones.

Edwards also founded Payphone Systems Acquisitions, Inc. (PSA). PSA was a whollyowned subsidiary of ETS. PSA purchased telephone equipment and locations, which it sold at wholesale to distributors. Edwards also is the principal owner of Twinleaf, Inc., a consulting company Edwards created to provide support services to ETS.

The SEC asserts Edwards used these entities collectively to engage in a single, larger venture involving the sale of securities, specifically investment contracts. An investor would purchase a pay telephone indirectly from PSA, subject to a provision whereby the purchaser had fifteen days to cancel the transaction. Then the purchaser would lease the phone "back" to ETS for

management in exchange for a fixed monthly fee. If at any time the purchaser was not satisfied with the arrangement, it could require ETS to purchase the phone for a prearranged price. Alternatively, it could cancel the lease and repossess its telephone without penalty. The SEC characterizes these transactions collectively as a "unit" sufficient to constitute a security under federal law. There is no dispute that Edwards did not register these transactions with the SEC.[1]

The immediate dispute arose when, in September 2000, ETS and PSA filed a voluntary petition for bankruptcy and reorganization. As a result, ETS stopped making lease payments to the telephone owners and ceased honoring the buyback guarantees. The SEC brought this action asserting Edwards engaged in widespread fraud. Specifically, the SEC alleges Edwards' business venture was actually a "massive Ponzi scheme." It argues Edwards did not operate a legitimate business but rather fleeced his investors by misrepresenting his company as profitable when it only survived because he constantly recruited new purchasers and used their capital to satisfy ETS's obligations. The SEC asserts Edwards sustained this fraud for over five years, raising more than $300 million from over 10,000 investors, with the full knowledge that eventu-

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[1] We note that Edwards conferred with SEC staff in Atlanta in 1995 concerning ETS's payphone program. Edwards and his lawyers provided documents and records to the SEC and met with an SEC attorney. At that time, the record shows the SEC attorney was told the marketing and leasing aspects of ETS's business would be separated to avoid any claim that the payphone business involved a security. The SEC took no action and did not contact Edwards until the year 2000 when ETS filed for bankruptcy and reorganization.

ally the stream of new investors would dry up and only he would profit while his investors lost everything.

To prevent this perceived injustice, the SEC's suit prayed for disgorgement of any profits Edwards may have made as a result of his business dealings. The merits of this suit, however, are not before the court. We only review the district court's grant of a preliminary injunction and freeze of Edwards' assets. Edwards asserts various grounds of error, including an absence of subject matter jurisdiction and abuse of discretion in granting the injunction and asset freeze. We hold the district court lacked subject matter jurisdiction to entertain this action; under the circumstances, we need not consider the other issues.

Jurisdiction

Edwards challenges the district court's subject matter jurisdiction to grant relief to the SEC, arguing the sale of pay telephones does not involve securities under federal law. Specifically, Edwards argues these transactions did not involve investment contracts. In order to defeat a jurisdictional attack on a preliminary injunction, the SEC must establish "a reasonable probability of ultimate success upon the question of jurisdiction when the action is tried on the merits." *SEC* v. *Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1198 (11th Cir. 1999) (quoting *Majd-Pour* v. *Georgiana Cmty. Hosp., Inc.*, 724 F.2d 901, 902 (11th Cir. 1984)). The Supreme Court has established a three part test for determining whether a particular financial interest constitutes an investment contract and, thus, a security. In *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-99, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), it held that an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to

expect profits solely from the efforts of the promoter or a third party . . . ." Thus, the Supreme Court has characterized a transaction as an investment contract if it involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits to be derived solely from the efforts of others. We agree with the district court that an investment of money is apparent. We address the remaining requirements in turn.

A. Common Enterprise

As Edwards points out, there is disagreement among the circuits as to the requirements of the second prong of the *Howey* test. Most circuits that have considered the issue find it satisfied where a movant shows "horizontal commonality," that is the "pooling" of investors' funds as a result of which the individual investors share all the risks and benefits of the business enterprise. *See, e.g., SEC* v. *Infinity Group Co.*, 212 F.3d 180, 188 (3d Cir. 2000).[2]

Edwards asserts the test for a common enterprise in this circuit is not settled and urges the court to adopt horizontal commonality. Notwithstanding Edwards' argument, we believe we are bound by precedent to apply a different test for commonality, "broad vertical commonality." *See SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999); *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974). Broad vertical commonality, the

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[2] *See also SEC* v. *Banner Fund Int'l*, 211 F.3d 602, 614-15 (D.C. Cir. 2000); *SEC* v. *Life Partners, Inc.*, 87 F.3d 536, 543-45 (D.C. Cir. 1996); *Teague* v. *Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994); *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018-19 (7th Cir. 1994); *Revak* v. *SEC Realty*, 18 F.3d 81, 87-89 (2d Cir. 1994); *Newmyer* v. *Philatelic Leasing, Ltd.*, 888 F.2d 385, 391-93 (6th Cir. 1989).

easiest to satisfy of the alternative tests, only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns. We need not explore the applicability of this prong to the present case, however, in light of our holding that the last prong, "expectation of profits," clearly is unsatisfied.

B. Expectation of Profits Solely from the Efforts of Others

The SEC cannot show a reasonable probability of success on the merits because it cannot show that investors who contracted with ETS expected profits to be derived solely through the efforts of others.

The SEC argues "profits" must be understood in a general sense. It notes that, in *United Housing Found.* v. *Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975), the Court stated that an investor is "'attracted solely by the prospects of a return' on his investment." *Id.* at 852, 95 S. Ct. 2051 (quoting *Howey*, 328 U.S. at 300, 66 S. Ct. 1100). The definition of profits, the SEC asserts, must be understood in terms of the nature of an investment. Here, ETS's investors purchased their telephones for the purpose of earning a return on the purchase price. Thus, the SEC urges, this should be enough to justify a finding of expectation of profits.

Although the simplicity of the SEC's proposed approach is naturally appealing, we must disagree. In *Forman*, the Court made clear that the word "profits" has a limited meaning under federal securities law. Profits, in that context, require either a participation in earnings by the investor or capital appreciation. *See id.* at 852, 95 S. Ct. 2051 ("By profits, the Court has meant

either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . ."). In this case, there is no dispute that capital appreciation is not at issue. Moreover, the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings; owners were not looking for any profit in the sense that they would receive earnings from the company. The owners certainly had no intention to share in the concomitant risk that their participation in the company's earnings would occasionally require them to share company losses. Of course, the funds generated by the payphones helped ETS meet its obligations. But this does not justify characterization as participation in earnings. Because the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant. ETS alone shouldered the risk of its placement of the telephones and ETS alone depended upon the earnings of its business. Thus, only ETS could reap profits as that term is understood under the federal securities law.

Even in the event the investors' return could be considered profits, the final *Howey* prong cannot be satisfied because the investors did not expect profits to be derived solely from the efforts of others. The parties dispute the level of control over the telephones the investors retained under the leaseback agreements. *See Albanese* v. *Florida Nat'l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987) ("If the investor retains the ability to control the profitability of his investment, the agreement is no security."). The SEC asserts the investors desired their telephones to be passive investments; Edwards urges the investors' right to cancel the

lease and repossess their telephones, or not contract with ETS at all for that matter, constitutes sufficient control under the *Albanese* standard. In our opinion, however, the determining factor is the fact that the investors were entitled to their lease payments under their contracts with ETS. Because their returns were contractually guaranteed, those returns were not derived from the efforts of Edwards or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract.

Because the SEC cannot satisfy the requirements of the *Howey* test to prove the existence of a security, we hold the district court did not have subject matter jurisdiction under the federal securities laws. The decision of the district court issuing a preliminary injunction and asset freeze is REVERSED with directions to dismiss the SEC's complaint for lack of subject matter jurisdiction.

LAY, Circuit Judge, concurring:

I concur with the judgment set forth in the majority opinion. The SEC cannot carry its burden to prove that Edwards' lease program involved an expectation of profits to be derived solely from the efforts of others. Consequently, there is no investment contract under *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), and no subject matter jurisdiction.

I write separately, however, to state my disagreement with that portion of the opinion which reaffirms broad vertical commonality as the test for common enterprise in the Eleventh Circuit. For the reasons set forth below, I respectfully submit that horizontal commonality is the only valid test for a common enterprise. Moreover, the SEC cannot carry its burden to prove horizontal commonality, and therefore, subject matter jurisdiction also is absent on this basis.

Requiring proof of horizontal commonality is the only logical approach to understanding the concept of a common enterprise. In *Curran* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980), the court set forth the widely accepted justification for this position. Proof of horizontal commonality is required because requiring only proof of broad vertical commonality makes *Howey's* third prong-expectation of profits to be derived from the efforts of others-superfluous. *Curran*, 622 F.2d at 221-24 (citing *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274, 275-77 (7th Cir.), cert. denied, 409 U.S. 887, 93 S. Ct. 113, 34 L. Ed. 2d 144 (1972) (Stevens, J.)). "[N]owhere in *Howey* or later Supreme Court decisions is it intimated that ['common enterprise'] is somehow redundant of other elements of the definition of a security." *Id.* at 224 (quoting *Ber-*

man v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979)). Consequently, only a requirement of horizontal commonality is consistent with the *Howey* test for an investment contract.[1] Indeed, in its arguments in a case out of the First Circuit, the SEC concedes that this reasoning is correct and broad vertical commonality is an inappropriate test for *Howey's* common enterprise requirement. *See* Brief for Appellant Securities and Exchange Comm'n at 28 n.11, *SEC* v. *SG Ltd.*, 265 F.3d 42 (1st Cir. 2001) ("The Commission has also long taken the position that broad vertical commonality is not an appropriate test because it collapses the second prong of the *Howey* test (common enterprise) into the third prong (profits to come from the efforts of others).").

The SEC responds that analysis of the present case under a requirement of horizontal commonality is inappropriate, however, because this circuit requires only proof of broad vertical commonality under *SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999); *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990); and *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir 1974). The

[1] The Sixth Circuit relied a great deal on the decision of the Seventh Circuit in *Milnarik*, 457 F.2d at 274, written by then-Judge Stevens. The *Curran* court, following the reasoning of *Milnarik*, observed:

> [W]e believe that no horizontal common enterprise can exist unless there also exists between discretionary account customers themselves some relationship which ties the fortunes of each investor to the success of the overall venture. Thus in our view the finding of a vertical common enterprise based solely on the relationship between promoter and investor is inconsistent with *Howey*.

Curran, 622 F.2d at 223-24.

majority opinion finds this argument controlling. With all due respect to the law of this circuit, which I am bound to follow as a visiting judge, I must respectfully disagree that this panel is bound by precedent to require only proof of broad vertical commonality.

To the extent the SEC relies on *Unique Financial Concepts* and *Eberhardt*, the SEC's argument is unpersuasive. In these cases, the respective panels relied on a prior panel opinion in *Villeneuve* v. *Advanced Bus. Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983), for the proposition that the Eleventh Circuit adheres to the broad vertical commonality test. Such reliance is misplaced.[2] The *Villeneuve* panel decision was vacated in an en banc decision. 730 F.2d 1403, 1404 (11th Cir. 1984). The en banc court did not address that part of the panel opinion where the court adhered to the broad vertical commonality test and, thus, did not reinstate the panel's decision in that respect. When the full circuit court vacates a panel decision and hears a case en banc, the panel opinion and judgment are totally vacated and, thus, have no precedential value in whole or in part. *See* 11th Cir. R. 26(k). The only binding authority is the decision of the en banc court and the opinion supporting that decision. *Cf. United States* v. *Rice*, 635 F.2d 409, 410 n. 1 (5th Cir. 1981) (noting that a vacated panel decision "constitutes no precedent"). As such, *Unique Financial Concepts*[3] and *Eberhardt*, er-

[2] The district court in the present case likewise mistakenly relied on the *Villeneuve* panel decision.

[3] It should be noted that, notwithstanding its purported reliance on broad vertical commonality, the *Unique Financial Concepts* court based its decision on the fact that the "investors' funds [were to] be pooled and apportioned proportionately by Appellants

roneously relying on the vacated panel decision in *Villeneuve*, offer no precedent for the proposition that the Eleventh Circuit requires only proof of broad vertical commonality.

The only question concerning the court's authority to require proof of horizontal commonality comes from *Koscot*, a case out of the Fifth Circuit, which arguably binds the court notwithstanding the intervening repudiation of the theory it espoused.[4] *Koscot*, however, is no longer good law and, therefore, we are not bound by it. *See Smith* v. *GTE Corp.*, 236 F.3d 1292, 1303 n.11 (11th Cir. 2001) ("Subsequent panels are not bound by prior decisions where there has been a change in the controlling law as a result of a subsequent . . . Supreme Court decision . . . ."). [5] This court has twice noted-prior to the overruled panel decision in *Villeneuve*-that it "has yet to decide whether *Koscot* and the line of cases following it conflict with *Howey* and [*United Housing Found. Inc.* v. *Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975)]." *Phillips* v. *Kaplus*, 764 F.2d 807, 816 n.9 (11th Cir. 1985) (citing *Villeneuve*, 730 F.2d at 1404 n.2). I believe that *Koscot* does conflict with *Howey*, per the analysis above, and *Forman*.

In *Forman*, 421 U.S. at 852, 95 S. Ct. 2051, the Supreme Court reiterated that an investment contract re-

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to each account." 196 F.3d at 1200. Thus, the court actually relied on the proofs necessary to show horizontal commonality.

[4] In 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), this court adopted as binding precedent all decisions of the former Fifth Circuit handed down prior to October 1, 1981.

[5] In fact, in *Long* v. *Shultz Cattle Co., Inc.*, 896 F.2d 85, 88 (5th Cir. 1990), the Fifth Circuit has indicated a willingness to review the vertical commonality test in an appropriate case.

quired "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." It also stated, however: "The focus of the [Securities] Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors." 421 U.S. at 849, 95 S. Ct. 2051. *Koscot's* broad vertical commonality test, which would include within the purview of a common enterprise even relationships between independent individual "investors" and a single "promoter," is antithetical to the *Forman* Court's notion that the federal securities laws focus on the protection of broader capital markets. Moreover, as discussed in the majority opinion, the *Forman* Court limited the definition of profits to capital appreciation or a participation in earnings. *See id.* at 852. These types of financial return are much more likely to be associated with participation in the broader capital markets where investors' funds are pooled in a single enterprise. In the present case, there was no pooling of money in a common venture; thus, it is my opinion that this case does not fit within *Forman's* understanding of common enterprise.

When the horizontal commonality test is applied to these facts, it is clear that the SEC also cannot carry its burden to show a common enterprise under *Howey*. The SEC asserts horizontal commonality can be found in the fact that Edwards operated a "massive Ponzi scheme." I disagree. The typical Ponzi scheme involves a fraudulent business venture where early investors are paid off by funds obtained from later inves-

tors, rather than the business itself, with the intent of using that early "success" to entice further investment in the sham venture. *See Official Comm. of Unsecured Creditors* v. *R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 343-44 n.1 (3d Cir. 2001) (citing Black's Law Dictionary 1180 (7th ed. 1999)). The fact that a fledgling business uses capital rather than earnings to pay debts, however, does not automatically indicate a Ponzi scheme. It is widely recognized in the commercial world that new businesses often do not show a profit in their early years; the only way to pay debt frequently is through the recruitment of new capital. Thus, it is the nature of the business as a sham which is the crucial consideration. Here, the record indicates that ETS made a good faith effort to run a legitimate business. It dutifully managed the phones it leased for the duration of its existence and continues to do so today under its reorganization plan. At its height, it had offices in twenty-eight states and Mexico and employed 550 people. Neither fact indicates that ETS was a fraudulent enterprise, "[un]supported by any underlying business venture," *see Bald Eagle Area Sch. Dist.* v. *Keystone Fin. Inc.*, 189 F.3d 321, 323 n.1 (3d Cir. 1999) (internal citation omitted), as the SEC would have us believe.

Apart from allegations of a Ponzi scheme, the SEC cannot show horizontal commonality on the facts presented. ETS entered into distinct contracts with each investor; it did not pool their funds. *See Curran*, 622 F.2d at 222 (finding a pooling of investors' interests essential to a finding of common enterprise). The success of one investor's contract had no direct[6] impact on the

[6] The SEC argues all "investors" in ETS shared the risk that it would go bankrupt and become unable to make lease payments; thus, it argues they are all "intertwined." This argument should be rejected as casting far too broad a net, contrary to the Court's teaching in *United Housing Found.* v. *Forman*, 421 U.S. 837, 857 n.24, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) (stating that mere "risk of insolvency . . . 'differ[s] vastly' from the kind of risk of 'fluctuating' value associated with securities investments") (internal citation omitted).

success of any other; the investors were not "inextricably intertwined." *SEC* v. *SG Ltd.*, 265 F.3d 42, 52 (1st Cir. 2001); *Union Planters Nat'l Bank of Memphis* v. *Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1183 (6th Cir. 1981). The investors were entitled to a guaranteed lease payment; only ETS bore the risk of failure and it alone would have enjoyed the benefits had its business prospered. Every indication is that there was no horizontal commonality inherent in Edwards' lease program. Consequently, subject matter jurisdiction fails on this basis as well.

APPENDIX B

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF GEORGIA

No. Civ. A. 1: 00-CV2532JTC

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF

v.

ETS PAYPHONES, INC.,
AND CHARLES E. EDWARDS, DEFENDANT

Filed: Nov. 20, 2000

ORDER

CAMP, District Judge.

This case is before the Court on Plaintiff Securities and Exchange Commission's Motion for Preliminary Injunction [# 3-1].

I. PROCEDURAL BACKGROUND

The Security and Exchange Commission ("Commission") brings this suit against ETS Payphones, Inc. and Charles E. Edwards for fraudulent and unregistered offering of securities in violation of the registration and anti-fraud provisions of the federal securities laws and seeks injunctive and other relief. Defendant ETS, who has filed for bankruptcy protection, consented to the injunction without admitting Plaintiff's allegations. Defendant Edwards, however, contends that (1) the

sale/leaseback of pay telephones does not constitute a security; (2) the Commission is not entitled to an injunction because Defendant Edwards is not likely to continue selling these securities; and (3) the asset freeze sought by the Commission upon Defendant Edwards is unwarranted.

The Court finds that the Commission has produced sufficient evidence to support an injunction and makes the following findings of fact and conclusions of law:

II. FINDINGS OF FACT

ETS Payphones, Inc. ("ETS") is a Georgia Corporation founded by Charles E. Edwards ("Edwards") in October 1994. For the past five years, ETS has offered and sold coin-operated telephones in units including a telephone, site lease, lease/back agreement, and buy/back agreement. An investor will pay $6,750.00 to ETS for a pay telephone, and ETS leases the telephone back from the investor for a fixed fee. The investor can, at his option, require ETS to repurchase the equipment at the end of the lease period or upon 180 days notice. Under the lease agreement, investors retain little, if any, control. Instead, Defendant manages, maintains, and operates the pay phones.

ETS offered and sold these investments to the general public through distributors and sales forces made up largely of licensed insurance agents. In their marketing efforts, ETS and its distributors used the mail and means such as internet websites to market the investments. However, ETS has not registered the sales as securities pursuant to the Securities Acts.

ETS advertised in sales literature that portrayed the company and its officials as experienced and successful in the telephone industry. Marketing brochures dis-

cussed the "profitability" of payphones and encouraged investors to "watch the profits add up." (Pl.'s Ex. 17). ETS websites noted the "profitable" opportunities for investors, and distributors offered individuals a fixed annual return of 14.1% on investments. (Pl.'s Ex. 22, 24).

Unfortunately for investors, these brochures, advertisements and websites failed to disclose the financial condition of the company. In reality, ETS always lost money on its payphone operations. In the first six months of this year, ETS lost more than $33 million. (Pl.'s Ex. 1). Similarly, from November 1998 to March 1999, ETS had an operating loss of $32 million. (Pl.'s Ex. 4). Because revenue from payphone operations never covered operating expenses, ETS had to attract an ever expanding number of investors to meet its obligations to existing investors. However, none of this information was disclosed. Instead, ETS continued to advertise the "profitability" of pay telephones, emphasizing the opportunities for investors to "watch the profits add up." (Pl.'s Ex. 17).

Despite these losses, Edwards continued to personally profit from the operation, receiving $2.24 million in compensation from ETS and Twinleaf, Inc. between 1998 and 2000. (October 12, 2000, Hearing Tr., pp. 68-69). He currently owns real estate worth more than $7 million. Similarly, a number of wholly owned subsidiaries also profited from ETS. From November 1998 to March 1999, ETS paid $3 million in management fees to an affiliated company owned by Edwards. (Pl.'s Ex. 4, Note H). Moreover, ETS financial statements indicate that the company transferred more than $11.6 million in interest free loans to companies controlled by Edwards. (Pl.'s Ex. 2, 4).

As owner/operator of ETS, Edwards directed company affairs, contracted with distributors to market telephone units, reviewed sales literature, and understood the true financial condition of the company. On September 11, 2000, ETS Payphones, Inc. filed for bankruptcy.

III. CONCLUSIONS OF LAW

To obtain an injunction under Section 20(b) of the Securities Act of 1933 and Section 21(d) of the Securities and Exchange Act of 1934, the Commission must establish the following: (1) a prima facie case of previous violations of federal securities laws, and (2) a reasonable likelihood that the wrong will be repeated. *See SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 n.2 (1999).

A. Prima Facie Case

Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act define a "security" to include an "investment contract." *See* 15 U.S.C. § 77b(a)(1) and 78c(a)(10) (1997). An investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-99, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946). The Eleventh Circuit has divided the *Howey* test into three elements: "(1) an investment of money; (2) a common enterprise; and (3) the expectation of profits to be derived solely from the efforts of others." *Villeneuve* v. *Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983*), aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984). For purposes of this case, only the second and third elements merit discussion.

1. Common Enterprise

In order to satisfy the second element of the *Howey* test, the Commission must establish that individuals invested money in a "common enterprise." A common enterprise exists where "the fortunes of the investor are interwoven with and dependant on the efforts and success of those seeking the investment or of third parties." *SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 (11th Cir. 1999) (quoting *Villeneuve*, 698 F.2d at 1124). The thrust of this test is that "investors have no desire to perform the chores necessary for a return." *Id.* at 1200 (quoting *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990)). Instead, "the requisite commonality is evidenced by the fact that the fortunes of all investors are tied to the efficacy of the promoter." *Id.* (quoting *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)). Because emphasis is placed upon the relationship between the investors and the promoter, this concept is referred to as "vertical commonality."

Defendant argues that other courts have defined "common enterprise" as one which requires investors to share or pool funds in order to succeed in a venture. *See Revak* v. *SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994); *Stenger* v. *R.H. Love Galleries, Inc.*, 741 F.2d 144 (7th Cir. 1984); *Newmyer* v. *Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989). Under this definition, plaintiffs must demonstrate that the fortunes of individual investors are "inextricably intertwined by contractual and financial arrangements to that of any other investors." *Cooper* v. *King*, No. 95-00289, 1997 WL 243424 at *2 (6th Cir. May 9, 1997). This concept is referred to as "horizontal commonality." Defendant's

scheme may amount to "horizontal commonality," but that is not the definition this court must apply.[7]

In this case, investors' fortunes are inextricably tied to Defendant Edwards and ETS. Investors purchase a pay phone for $6,750, lease it back to ETS, and receive a monthly payment as a return on their investment. They have no control over the pay phone and do not participate in its operation. Instead, Defendant manages and maintains the pay phone, offering to repurchase it upon termination of the lease. Recovery of this investment, however, depends upon the financial viability of the company and Defendant's ability to generate a profit. Therefore, the fortunes of investors are linked to the efficacy of the promoter. This program satisfies the common enterprise element of an investment contract.

2. Expectation of Profits

In order to satisfy this element of the *Howey* test, Plaintiff must establish that investors expect profits to be derived "solely from the efforts of the promoter or third party." *Howey*, 328 U.S. at 299, 66 S. Ct. at 1103. If the investor controls the profitability of his investment, the agreement is not a security. Therefore, the "crucial inquiry is the amount of control that the investors retain under their written agreements." *Albanese*

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[7] Unfortunately, neither definition of "common enterprise" adequately addresses the purpose of the federal securities laws—to protect potential and actual investors from fraud. A broader definition of commonality should protect individual investors who rely solely on the "efficacy" of the promoter, as well as multiple investors who "pool" their funds in order to share the risks and profits. *See* Marc G. Alcser, *The Howey Test: A Common Ground for the Common Enterprise Theory*, 29 U.C. Davis L. Rev. 1217 (1996).

v. *Florida Nat'l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987). In *Albanese*, investors purchased an ice machine, leased it back to the company, and received a monthly return on investment. The company managed, maintained, serviced and operated the machines. Investors, however, were allowed to select the locations of the machines. *Id.* at 410.

The Eleventh Circuit concluded that this enterprise satisfied this element of the *Howey* test because investors expected profits to be derived solely from the efforts of others. While investors retained some control over their machines, this control was "insubstantial" and "illusory" because (1) the power to specify locations was limited to sites already procured by the corporation; (2) the corporation offered its expertise in finding locations, contracting with hotels, servicing the machines, and accounting for profits; and (3) the investors had no realistic alternative to allowing the corporation to manage their investments. *Id.* at 412; *see also*, *Unique Financial Concepts*, 196 F.3d 1195, 1201 (concluding that investors had no control over their investments and that profits were derived by defendant corporation under "any reasonable interpretation of 'solely'").

In this case, Defendants monitored, managed, and maintained the pay telephones assigned to investors. After contributing money, Plaintiffs had little, if any, involvement in the enterprise. Any control that Plaintiffs may have retained was "illusory" or "insubstantial" because Defendants assumed all responsibility for the payphones. Investors never saw the telephones, never used the telephones, and often did not know where they were located. Because profits were derived "solely"

from the efforts of the Defendant, the lease agreement satisfies the third element of an investment contract.

4. Violations

Since Defendant's payphone program is an investment contract, it is governed by the Securities and Exchange Acts. Section 5(c) of the Securities Act, 15 U.S.C. § 77e(a)(2), makes it unlawful to offer to sell a security for which a registration statement has not been filed. Similarly, Section 5(a) of the Securities Act, 15 U.S.C. § 77e(a)(3), makes it unlawful for persons to use any means or instruments of transportation or communication in interstate commerce or of the mails to sell a security for which a registration statement is not in effect. Thus, Defendants have sold unregistered securities to thousands of people in thirty-eight states for the last five years. In order to make these transactions, Defendants used the mails and other forms of media, including internet websites. These activities constitute prima facie violations of Sections 5(a) and 5(c) of the Securities Act. *SEC* v. *Continental Tobacco Co.*, 463 F.2d 137, 155 (5th Cir. 1972).

Furthermore, Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act proscribe fraudulent conduct in connection with the offer, purchase and sale of securities. *See* 15 U.S.C. § 77q(a) and 15 U.S.C. 78j(b). To establish a violation of these provisions, the Commission must show that Defendants (a) used jurisdictional means; (b) engaged in fraudulent schemes, practices or courses of business or made materially false or misleading statements; (c) in connection with the offer or sale of securities; and (d) for violations of Section 17(a)(1) and 10(b), acted with scienter. *Steadman* v. *SEC*, 603 F.2d 1126, 1131-33 (5th Cir. 1979), *aff'd*, 450 U.S. 91, 101 S. Ct. 999, 67 L. Ed. 2d 69 (1981).

Here, Defendant Edwards used the mails (to send promotional sales materials to distributors and investors) and instrumentalities of interstate commerce (e.g., an Internet web site to provide sales materials) in connection with the offer or sale of securities. Such activity satisfies the jurisdictional means requirement. *See Glick* v. *Campagna*, 613 F.2d 31, 35-36 (3d Cir. 1979).

Moreover, Defendant failed to adequately inform investors of the financial condition of the company. Investors were not told: (1) that ETS had failed to make a profit; (2) that ETS was losing money on its payphone program; and (3) that ETS depended on funds from new investors in order to sustain operations. Instead, investors were led to believe that both ETS and its payphone program generated a profit. These misrepresentations and omissions are material because they go to the essence of the investment decisions made by individual investors. *See Basic Inc.* v. *Levinson*, 485 U.S. 224, 231-32, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988) (determining that information is material and must be disclosed if there is a substantial likelihood that "the disclosure of the omitted facts would have been viewed by the reasonable investors as having significantly altered the 'total mix' of information made available.").

Finally, the Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S. Ct. 1375, 1381 n.12, 47 L. Ed. 2d 668 (1976). In the Eleventh Circuit, scienter may be shown by "severe recklessness," defined as "those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading

buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *McDonald* v. *Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989).

The misrepresentations and omissions made by Defendant amount to severe recklessness. Defendant was aware of the financial condition of ETS and the fact that ETS relied solely on funds from new investors in order to sustain operations. Despite this knowledge, Defendant marketed the program as a profitable enterprise "ringing with opportunity."

B. Reasonably Likely to Continue These Violations

In order to obtain a preliminary injunction, the Commission must also show that Defendant Edwards is reasonably likely to continue violating the securities laws. *See Unique Financial Concepts*, 196 F.3d at 1199 n. 2; *SEC* v. *Int'l Heritage, Inc.*, (Story, J) (concluding that an injunction is warranted if there is a "reasonable likelihood that Defendants are engaged or are about to engage in practices that violate federal securities law").

Analysis of a number of factors determines the likelihood of future violations. Courts must consider "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Id.* Courts place special emphasis on "proof of past substantive violations that indicate a reasonable likelihood of future substantive violations." *Id.*

The evidence in this case supports Plaintiff's request for a preliminary injunction. First, Defendant's actions were egregious in operating an investment scheme at a significant loss while only he profited. While the company lost millions, Defendant sponsored a NASCAR racing team, purchased a home on Sea Island, and received $700,000 in "consultant" fees from another payphone enterprise.

Second, Defendant's occupation presents opportunities for future violations. Defendant operates a number of wholly owned subsidiaries created to support, supplement, and develop the ETS pay phone enterprise. Because these companies may contain funds (in the form of loans) which are rightfully owned by ETS investors, a preliminary injunction is necessary to prohibit Defendant from using these subsidiaries to market similar investment programs.

Finally, Defendant acted with scienter because he knew that his conduct might violate securities laws. Over the past eighteen months Defendant received cease and desist order from courts in North Carolina, Kansas, and Rhode Island. Despite these warnings, Defendant continued to operate this enterprise. Because Defendant's conduct was egregious, systematic, and continuous for a number of years, a preliminary injunction is warranted.

C. Asset Freeze

The purpose of an asset freeze is to insure that any funds which may become due can be collected. *SEC* v. *Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990). In order to obtain an asset freeze, the Commission must show that it is likely to succeed on the merits of its claim. *SEC* v. *Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998). As stated in Part II of this Order, that standard has been met.

ETS, under Edward's control, engaged in the unregistered sale of securities in violation of federal law. Edwards profited from this enterprise, receiving approximately $15 million in the form of interest free loans and fees to companies that he owns. Edwards also received $2.24 million in compensation from Twinleaf and ETS, and currently owns real estate valued at $7 million. In order to preserve secure assets for disgorgement if it becomes appropriate, an asset freeze of Defendant Edwards' assets is necessary.

IV. CONCLUSION

For the foregoing reasons, Plaintiff's Motion for a Preliminary Injunction and Asset Freeze [# 3-1] is **GRANTED**.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-10107-DD

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

CHARLES E. EDWARDS, DEFENDANT-APPELLANT

On Appeal from the United States District Court
for the Northern District of Georgia

[Filed: Nov. 15, 2002]

ON PETITION(S) FOR REHEARING AND PETITION(S) FOR REHEARING EN BANC
(Opinion _____, 11th Cir., 19_____, _____F.2d_).

Before: EDMONDSON, Chief Judge, HILL and LAY, Circuit Judges.

PER CURIAM:

The petition(s) for Rehearing are DENIED and no Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc

(Rule 35, Federal Rules of Appellate Procedure), the Petition(s) for Rehearing En Banc are DENIED.*

Entered for the Court:

/s/ (Illegible)
CHIEF JUDGE

---

* Honorable Donald P. Lay, U.S. Circuit Judge for the Eighth Circuit, sitting by designation.

APPENDIX D

STATUTORY APPENDIX

1. Section 77b(a) of Title 15 of the United States Code provides in relevant part:

When used in this subchapter, unless the context otherwise requires—

> (1) The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest of participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

2. Section 78c(a) of the United States Code provides in relevant part:

When used in this chapter, unless the context otherwise requires—

* * * * *

> (10) The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(2)
Supreme Court, U.S.
FILED
MAR 13 2003
CLERK

No. 02-1196

In The
Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), include the term "investment contract" in the definition of "security." This Court has defined an investment contract to comprise an investment of money in a common enterprise with profits to be derived solely from the efforts of others. This Court has further explained that the term "profits" in the investment contract context means only capital appreciation from the development of the initial investment or a participation in earnings resulting from the use of investors' funds. This case concerns the purchase by individuals of pay telephone equipment and their subsequent lease of that equipment in exchange for monthly fixed lease payments. The question presented is: Did the court of appeals err when it held that the monthly fixed lease payments were not "profits" for investment contract purposes where the fixed lease payments represented neither capital appreciation nor a participation in the earnings of the enterprise?

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Charles E. Edwards submits that he does not have any parent corporations or subsidiaries.

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BRIEF IN OPPOSITION

Charles E. Edwards respectfully submits his Brief in Opposition to the Petition for Writ of Certiorari filed on behalf of the Securities and Exchange Commission ("SEC"), to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals is reported at 300 F.3d 1281 and is reproduced at Pet. App. 1a-15a. The order denying rehearing and rehearing *en banc* is reproduced at Pet. App. 28a-29a. The order of the district court is reported at 123 F. Supp. 2d 1349 and is reproduced at Pet. App. 16a 27a.

JURISDICTION

The judgment of the court of appeals was entered on August 6, 2002. The SEC's petition for rehearing and rehearing *en banc* was denied on November 15, 2002. The SEC's petition for writ of certiorari was docketed on February 14, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The text of 15 U.S.C. § 77b(a)(1) and 15 U.S.C. § 78c(a)(10) are reproduced at Pet. App. 30a-31a.

STATEMENT

Charles E. Edwards was the founder and controlling shareholder of ETS Payphones, Inc. ("ETS"), a Georgia corporation. ETS has been engaged in the business of operating coin-operated pay telephones since approximately 1994. Mr. Edwards was a member of ETS's board of directors and served as its chief executive officer until June 2000. ETS was one of the largest privately-owned pay telephone operators in the United States. As the SEC conceded in the court of appeals, ETS had 28 offices nationwide and four in Mexico and was managing 47,000 payphones in 38 states in locations such as fast food restaurants, convenience stores, gas stations, hotels, airports, and sports arenas. (SEC App. Br. at 5-6); *see also SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1288 (11th Cir. 2002). (Pet. App. 14a). (Lay, J., concurring). ETS has recently emerged from bankruptcy and currently owns and operates a system consisting of tens of thousands of pay telephones.

ETS presented pay telephone owners with three options regarding the services ETS offered. Two of these options, not at issue here, provided the pay telephone owner with a share in the profits of his or her particular pay telephone and, for a fee, ETS performed various management and maintenance duties. The third option was a lease plan. The lease option, the only plan relevant here, did not include any sharing in the profitability of ETS or the pay telephone.

Mr. Edwards otherwise incorporates by reference the statement of the facts by the court of appeals, reproduced at Pet. App. 2a-4a, as his statement of facts regarding ETS's business operations relevant to the question presented.

On November 22, 2000, the district court granted the SEC's emergency petition for a preliminary injunction, an asset freeze and other equitable relief against Mr. Edwards.[1] Even though Mr. Edwards pointedly raised the SEC's failure to prove that the monthly lease payments by ETS to pay telephone owners were a species of "profits" necessary to establish the existence of an investment contract (R2-11-21), the district court did not address the issue.

On appeal, the court of appeals reversed the order of the district court and held that the district court lacked subject matter jurisdiction to entertain the action because the SEC could not satisfy one of the essential elements of an investment contract under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946): the expectation of profits to be derived solely from the efforts of others. The court of appeals reasoned that the SEC could not reasonably demonstrate that the pay telephone owners, who had individual lease contracts with ETS, expected "profits" as that term was defined in *United Housing Found., Inc. v.*

[1] ETS, which was in bankruptcy, consented to the entry of a preliminary injunction before the evidentiary hearing on the SEC's motion.

Forman, 421 U.S. 837 (1975). Citing the test announced in *Forman* for "profits," which the SEC too had relied upon, the court of appeals reiterated that the definition of profits in the context of investment contracts requires either a participation in earnings by the investor or capital appreciation. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284. (Pet. App. 6a).[2] The court stated that "there is no dispute that capital appreciation is not at issue." *Id.* (Pet. App. 7a). The court reasoned further that the fixed lease payments were not a participation by the pay telephone owners in company earnings or losses, stating that "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." *Id.* at 1285. (Pet. App. 7a). The court of appeals concluded its "profits" analysis by stating that "only ETS could reap profits as that term is understood under the federal securities law." *Id.* Finally, the court noted, in *dicta*, that even if lease payments were a participation in profits, the third prong of the *Howey* test was still not satisfied because the rental payments "were derived as the benefit of the investors' bargain under the contract." *Id.* The court of appeals did not address whether the common enterprise

[2] The court of appeals determination that there was no subject matter jurisdiction was based on the evidentiary record compiled in the district court on the motion for a preliminary injunction and was not the result of a motion to dismiss addressed merely to the SEC's complaint. Thus, the SEC's references to the unsupported allegations of its complaint in the SEC's "Statement" (SEC Petition at 3-4) are not allegations that must be deemed true and should be disregarded. For example, the SEC's "facts" that as a result of misleading marketing ETS took in approximately $300 million from more than 10,000 investors or that Mr. Edwards "drained approximately $18 million from the company in direct compensation" has never been proven or found by any court.

prong of the *Howey* test was met since the last prong was clearly unsatisfied. *See id.* at 1284. (Pet. App. 6a). Judge Lay, in his concurring opinion, concluded that the SEC also had not shown a common enterprise, and stated that, contrary to the SEC's argument that ETS was a "Ponzi" scheme, and therefore fraudulent, the evidence showed that Mr. Edwards had made a good faith effort to run a legitimate business. *See id.* at 1288. (Pet. App. 14a). The court of appeals did not consider the other grounds of error presented by Mr. Edwards.

The SEC's petition for rehearing was denied. As no judge in regular active service on the court requested that the court be polled on rehearing *en banc*, its petition for rehearing *en banc* was also denied.

REASONS FOR DENYING THE WRIT

The decision of the court of appeals is consistent with prior decisions of this Court, is not in conflict with any other court of appeals, and is correct. Further review by this Court is therefore unwarranted.

The court of appeals applied the established rule of law set forth in *United Housing Found. Inc. v. Forman*, 421 U.S. 837 (1975), the limits of which were emphasized in *Reves v. Ernest & Young*, 494 U.S. 56 (1990), regarding what "profits" are for purposes of defining an investment contract under the well-recognized rubric of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The factual circumstances of the particular business venture involved here simply do not fit within the elements of an investment contract, specifically the third element, the expectation of profits derived from the efforts of others. At most, the asserted

error consists of the misapplication of a properly stated rule of law to those circumstances. The SEC's effort to expand the scope of the term investment contract into a "catch-all" provision of the federal securities laws in order to avoid the limits imposed by *Forman* and *Reves* is unprecedented.[3] Contrary to the SEC's contentions, there is no conflict with decisions of the Third Circuit or Ninth Circuit Courts of Appeals, this Court's own precedent, or previous SEC authoritative opinions and positions. Finally, the court of appeals decision does not impede or impair the SEC's ability to enforce the securities laws. In fact, the SEC filed and has successfully pursued a case virtually identical to the ETS case in the same district court some four months after the court of appeals decision. *See SEC v. Zanello*, Civil Action No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002).

I. The Court of Appeals Decision Is Consistent With The Court's Prior Decisions.

"Investment contract" is one of the general categories listed under the definition of "security," *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 n.5 (1985), and has

[3] Assuming *arguendo* that the SEC's claims of misrepresentation by ETS in its payphone business had merit, those claims would not justify the uncabined rule sought by the SEC. As the Court has observed, "congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (citations omitted). ETS has always been subject to regulation by the Federal Trade Commission ("FTC"). The FTC's disclosure regulation rule "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," *see* 16 C.F.R. § 436, applied to the disclosures and transactions described here and was followed by ETS. (Exh. 18; R2-11-23).

been used by the Court to identify "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Id.* at 689 n.4. In assessing whether one of these "unusual instruments" was an investment contract, the Court has applied an economic reality test, for, if the securities Acts were to apply in those cases at all, it would have to have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. *See id.* at 690. By 1933, the term's meaning had been crystallized by prior usage to the extent that Congress's use of the term had meaning. In accord with this historical treatment, the Court held that investors expecting capital appreciation from a business venture involving the sale of oil leaseholds, *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and investors expecting to share in the earnings of an orange grove venture, *Howey*, 328 U.S. 293, had acquired investment contracts, even though the interests they acquired were not one of the more traditional species of securities.

In *Howey*, the Court established, for federal law purposes, a three-part test for determining whether particular financial relationships are investment contracts. The Court held in *Howey* that there must be an investment of money in a common enterprise with an expectation of profits to be derived solely from the efforts of others. *Howey*, 328 U.S. at 301. With respect to what constituted "profits," the *Howey* Court was specific; it stated that the investors' "respective shares in [the] enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. . . . Thus, all the elements of

a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits. . . . " *Howey*, 328 U.S. at 300, 301.

In *Forman*, the Court explained what the term "profits" means in the investment contract context:

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds. . . .

Forman, 421 U.S. at 852 (citations omitted).[4] If any doubt remained as to what the Court meant by "profits" in the investment contract context, those doubts were put to rest in the unanimous portion of the Court's decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). The Court was unmistakably precise: it reiterated that the Court had "defined 'profit' more restrictively in applying the Howey test to what are claimed to be 'investment contracts,'" to encompass only capital appreciation and a participation in earnings, whereas the definition of "profit" in the context of "notes" was broader, meaning a valuable return on an investment, undoubtedly including interest. *Id.* at 68 n.4. The Court expressly "decline[d] to extend [*Howey's*] definition of 'profit' beyond the realm in which the definition applies" because the issue was not before the Court. *Id.*

[4] The dissent in *Forman* emphasized that the Court's restrictive definition of "profits" would exclude some forms of investments from the *Howey* test: the "Court must surprise knowledgeable economists with its proposition . . . that profits cannot assume forms other than appreciation of capital or participation in earnings." *Forman*, 421 U.S. at 863. (Brennan, J., Douglas, J., and White, J., dissenting).

The Court also pointed out that categories of securities not subject to this "restrictive definition" of "profit" were not required to have a return on investment "keyed to the earning of the enterprise." *Id.*

In its brief to the court of appeals, the SEC posited the *Forman* profits definition as the correct test, stating that profits are either the result of the appreciation of capital from the development of an initial investment or are a participation in earnings resulting from the use of investors' funds. (SEC App. Br. at 36). The SEC has never contended that lessors to ETS expected capital appreciation, and the SEC's only evidence of a participation in earnings by lessors was their receipt of their monthly lease payments, which the SEC argued were *Howey*-type profits, even though they were not "keyed" to ETS's earnings. Based on these facts, as noted above, the court of appeals disagreed with the SEC, and concluded that the SEC had not proven that lessors expected *Howey*-type profits. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1285. (Pet. App. 6a).

Obviously disappointed by that result, the SEC in its Petition now contends that the legal test applied by the court of appeals, fashioned as it was from consistent, long-standing and unquestioned precedent, amounted to "engrafting rigid technical limits" on the *Howey* test (SEC Petition at 13) and was "mistaken." (SEC Petition at 17). The SEC argues that one may participate in the earnings of an enterprise when that participation is not "measured" by the earnings; however, the SEC concedes, as it must, that its position is directly contrary to the Court's unanimous position in *Reves*. (SEC Petition at 18-19 n.6). In fact, the SEC now says that the Court in *Forman* was "simply describing one of its prior decisions" (SEC Petition

at 18) and the Court in *Reves*, like the court of appeals, was "mistaken." (SEC Petition at 19 n.6). In short, the SEC is seeking to extend the Court's definition of "profits" beyond the realm in which the definition applies.[5]

The SEC's effort to overcome this well-established meaning of "profits" for investment contract purposes is anchored by the SEC's contention that the term investment contract is a "catch-all" for all manner of investments not otherwise defined as securities. (SEC Petition at 12,[6] 13). By arguing that the term investment contract is a "catch-all," the SEC tacitly concedes that the facts here do not meet the well-established elements long recognized by this Court and the lower courts to determine the existence of an investment contract. Since first addressing the meaning of investment contract in the securities context fifty years ago, the Court has refined, explained and applied the contours of the term numerous times. Not once has the Court departed from the essential elements established in *Joiner* and *Howey*, or described the term investment contract as a "catch-all." Here, the SEC invites

[5] The SEC's position ignores the basic tenet that "settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves*, 494 U.S. at 74 (Stevens, J., concurring) (further commenting that after a statute is construed by the court or a course of other federal decisions (*see* pages 19-20, *infra*) "it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself").

[6] The support for its argument that the term is a "catch-all" is the SEC's citation to an off-hand comment in *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982) that uses the term "catch-all." (SEC Petition at 12). In that case, the court did not suggest that an investment contract did not have the defined elements identified by this Court's decisions.

the Court to determine for the first time that the term investment contract is a "catch-all" broad enough to "catch" transactions having some of the attributes of other distinct types of securities (here fixed periodic payments, which are characteristic of notes and other debt instruments) and not having those attributes historically associated with investment contracts, *to wit*, either an opportunity to attain capital appreciation or to share in the earnings of the common enterprise.[7]

In its zeal to convince this Court that the court of appeals erred, the SEC has lost sight of the issue in this case. It poses the question presented and argues repeatedly as though the court of appeals held that fixed returns could never be *Howey*-type profits. This mischaracterizes the holding of the court of appeals. It did not, as the SEC contends, hold "that an investment cannot be an 'investment contract' if the return is fixed rather than variable or if the investor is contractually entitled to a particular amount or rate of return." (SEC Petition at 9.) Rather, the court of appeals stated that "capital appreciation is not at issue" and held that "the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings; owners were not looking for any profit in

[7] Both the Securities Act's and the Securities Exchange Act's definition of "security" do include what can be deemed "catch-all" terms: " . . . or, in general, any interest or instrument commonly known as a 'security' . . . " (15 U.S.C. § 77b(a)(1)); " . . . or in general, any instrument commonly known as a 'security' . . . " (15 U.S.C. § 78c(a)(10)). By preceding the definition of "security" in both Acts by the preface " . . . 'unless the context otherwise requires' . . . ," Congress sought to avoid the unfettered usage for the listed terms urged by the SEC. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (citations omitted).

the sense that they would receive earnings from the company." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284. (Pet. App. 7a). The necessity for a variable return was not a question posed to or decided by the court of appeals.

The question presented by this case that determines the presence of federal jurisdiction is whether the lease payments here satisfy the definition of profits established by *Forman* and solidified by *Reves*. The SEC protests too much in claiming that the court of appeals' decision, "opens a seemingly limitless gap" in investor protection against fraud (SEC Petition at 8) and "opens an immense loophole in the definition of security" (SEC Petition at 13) by eliminating from coverage promoters' offerings that carry a fixed or specified, rather than a variable, return. Despite this hyperbole, the decision did not turn on whether the payments were fixed or variable and no loophole was opened. In contending that the Court should take this case to hold that a fixed payment not derived from capital appreciation or a participation in earnings is a *Howey*-type profit, the SEC does not write on a clean slate: this same position was advanced by the SEC in its *amicus* brief in *Reves* (Br. for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480)); nevertheless, the Court unanimously and explicitly announced a contrary view. Nothing in the law has changed to suggest that the SEC is any more correct in this position now than it was then. On several other occasions, this Court has rejected the SEC's efforts to extend the realm of *Howey*. *See, e.g., Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979) (citing cases). It should do so again. In this case, the court of appeals applied an established and correct rule of law and its decision should not be disturbed.

In seeking to extend the definition of "profits," the SEC points to the literal meaning of "guaranty," "invest," "investing," "income," "contract," and "profit." (SEC Petition at 10-11). But, the mature and developed jurisprudence of what constitutes an investment contract counsels against " . . . mak[ing] a fortress out of the dictionary." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945) (L. Hand, J.), *aff'd*, 326 U.S. 404 (1945); *Public Citizen v. U.S. Dept. of Justice*, 491 U.S. 440, 454-55 (1989) (explaining that the plain meaning rule in statutory construction is "rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists") (citations omitted). The Court's teachings stress that an examination of economic realities underlying a transaction, in light of the purposes of the securities laws, will identify what is or is not an investment contract. *Forman*, 421 U.S. at 849. The economic realities of the ETS business enterprise presented by the record here show that lessors parted with their money to acquire a pay telephone to use for commercial purposes and then they entered into a lease agreement providing for a fixed monthly payment, an expense which ETS could pay from many sources, not "keyed" to ETS's or the pay telephones' earnings, such as revenues, borrowings, asset sales, payments from a subsidiary, or otherwise. Earnings of the business would be available only after its expenses were paid.

Confronted by its lack of proof of a "profit" expectation by lessors, which it characterizes as investors, the SEC shifts the focus and contends that, according to *Reves*, Congress's goal was to regulate investments in whatever form they are made and by whatever name they are called.

For proof that these were "investments" promising "profits," the SEC argues that the marketing materials allegedly used by ETS to sell pay telephones should control as to whether profits were expected by lessors for *Howey* purposes, citing *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) and *SEC v. United Benefit Life Insur. Co.*, 387 U.S. 202 (1967). (SEC Petition at 16-17). Putting aside the fact that the SEC inaccurately describes the marketing materials, who used them, and to whom they were directed, the Court has not used marketing materials as the sole test of whether a particular instrument is an investment contract.[8] Rather, the Court has "repeatedly held that the test '"is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."'" *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982), citing *SEC v. United Benefit Life Insur. Co.*, 387 U.S. 202, 211 (1967) and *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-353 (1943). Here, the instruments

[8] The SEC's reliance on marketing materials that read "watch the profits add up" and described "steady immediate cash flows" is misplaced. (SEC Petition at 3, 17). Those materials (Exh. 17, 22) were directed to property site owners, such as convenience store owners, who were solicited to have pay telephones installed on their property and who would receive a share of the installed pay telephones' revenues, or were used to market ETS's management services and not the lease option. (R11-59). Other marketing materials referenced by the SEC (Exh. 15) were not used by ETS (R11-59) or were withdrawn from evidence by the SEC for lack of foundation (Exh. 14) and thus are not part of the record. (R11-100). The ETS marketing materials for the lease plan stated that ETS's profits or the individual lessor's pay telephone revenues were separate from the monthly rental amount that was to be paid to the lessor as rent. (Exh. 18). The SEC thus paints with too broad a brush in contending that lessors were told they were able to share in any "profits." (SEC Petition at 17).

were in fact lease agreements, were offered and executed as lease agreements, and the economic inducement was a fixed monthly lease payment. These were not "unrealistic and irrelevant formulae." *Howey*, 328 U.S. at 301. That other options for commercialization of pay telephones were discussed in the ETS marketing materials and were offered to pay telephone owners does not alter the essential attributes of the instruments involved here. Despite the inaccurate descriptions by the SEC of these marketing materials, the fact of the matter is that the pay telephone owners involved in this case chose the option offered by ETS that gave them nothing more than an expectation of a fixed monthly rental payment in exchange for ETS's use (or even non-use) of their pay telephones.

After holding that the lease payments were not profits under the *Forman* formulation, the court of appeals observed that the final prong of *Howey* was not satisfied in any event "because the investors did not expect profits to be derived solely from the efforts of others." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1285. (Pet. App. 7a). According to the court of appeals, "the determining factor [was] the fact that the investors were entitled to their lease payments under their contracts with ETS" and the returns were "derived as the benefit of the investors' bargain under the contract." *Id.* The lessors stood to recover no more nor less than the lease payments and ETS's efforts, or lack of them, could not change that amount or alter the lessors' rights under the agreement. Once the lessors agreed to lease their pay telephones to ETS, the lessors retained the ability to terminate their agreements, switch to a management plan, repossess their pay telephones, contract with one of the many other pay telephone management companies (R11-52-53), assign their interests, or

sell their pay telephones at the purchase price (on 180 days' notice or after the five-year term of the lease) to ETS, or someone else at market price. And, because these were lease agreements, the district court's findings that ETS "assumed all responsibility for the payphones" and the "[i]nvestors never saw the telephones, never used the telephones, and often did not know where they were located," *SEC v. ETS Payphones, Inc.*, 123 F. Supp. 2d 1349, 1354 (N.D. Ga. 2000) (Pet. App. 22a), were truisms simply irrelevant to the analysis. The court of appeals *dicta* complained of by the SEC was consistent with *Howey*.[9]

II. The Court of Appeals Decision Does Not Present A Conflict Among The Courts of Appeals.

The SEC's Petition should be denied because there is no intercircuit conflict. Among *SEC v. The Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *United States v. Carman*, 557 F.2d 556 (9th Cir. 1978), and this case there are factual differences, but the rule of law applied by the courts is the same despite the SEC's attempts to place them in conflict. The fact that *Infinity Group* and *Carman*

[9] The claim in the Petition that the court of appeals should have *sua sponte* remanded this case to the district court to consider whether the instruments here were "notes" or other "evidences of indebtedness" is without merit. (SEC Petition at 20 n.7). First, there was no note and the lease agreements do not meet the legal test for notes. Second, and more importantly, neither the SEC's complaint and its proofs at hearing nor its brief to the court of appeals even mentioned the theory that these were notes or other evidences of indebtedness. Neither the district court nor the appellate court entertained this contention. Thus, neither should this Court.

stated that the return on investment was "fixed" was not controlling as to their respective decisions that the *Howey* test had been met.[10]

Carman did not even mention Forman or its "profits" formulation. *Carman's* focus was to determine if a common enterprise was present, finding one because the success of both promoter and investor, despite the latter's fixed return, was dependent upon the promoter's continued solvency. *Carman*, 557 F.2d at 563. *Carman* does not, as the SEC suggests (SEC Petition at 22), lend support to its argument for an extension of the "profits" aspect of the *Howey* test. Subsequent Ninth Circuit decisions have cited the language from *Carman* relied upon by the SEC, but only with reference to the common enterprise element of the *Howey* test. *See SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994); *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985); and *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978). Two years after *Carman*, the same court, in *Noa v. Key Futures, Inc.*, 638 F.2d 77, 80 (9th Cir. 1980), established that the risk of insolvency alone is insufficient to establish the requisite dependency for a common enterprise. *See SEC v. Belmont*

[10] Both cases relied upon *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974), a pre-*Forman* case that relied upon promised tax benefits as a type of profit meeting the *Howey* test, a notion discredited by *Forman*. *Forman*, 421 U.S. at 855 n.20. In any event, the court in *El Khadem* expressly stated that its holding did not apply to cases where the investor "borrower" seeking tax benefits would not face an out-of-pocket loss in return for financial gain, such as where the investor's collateral could be redeemed. *El Khadem*, 494 F.2d at 1230 n.14. Here, the lease agreement provided that the pay telephone owner could repudiate the lease agreement and reclaim his or her pay telephone at any time.

Reid & Co., Inc., 794 F.2d 1388, 1391 (9th Cir. 1986) (also citing *Noa* and noting that the greatest risk to the purchaser was the failure of the enterprise but that this was insufficient to meet the third prong of *Howey* because of its ready applicability to any sale-of-goods contract).

Infinity Group noted that the defendants did not contest the "third prong[ ] of the *Howey* test" and, after a cursory treatment that did not mention *Forman*, agreed that the profits from the efforts of others element was met. *SEC v. The Infinity Group Co.*, 212 F.3d at 187. The "focus [of its] analysis [was] upon the 'common enterprise,' or second prong, of the *Howey* test." *Id.* In this analysis, the *Infinity Group* court looked to the *Forman* "profits" formulation to determine if the investment scheme involved a "common enterprise," concluding that it did because the profits of the enterprise were shared, with a set percentage amount going to the investors. As the Petition notes, purchasers of the property transfer contracts in the *Infinity Group* case parted with their money to be pooled in trusts and invested at the trustee's discretion. (SEC Petition at 21). The "guarantee" or fixed return that the SEC points to as an inter-circuit conflict misses a step in the *Forman* profit analysis. The guarantee that the investors would be paid a portion of the trust's earnings as dividends ranging between 138% to 181% of their investment amount is pointedly different than the expectation that ETS would pay the expenses associated with its fixed lease obligations on the pay telephones. *SEC v. The Infinity Group Co.*, 212 F.3d at 184. In the former, even though fixed in percentage, the dividend derived from a participation in the earnings of the trust. The representations that investors could expect a specific percentage gain in the form of dividends only reinforces the view that these

were payments to be made as a result of earnings on the investors' funds, a fact that fits squarely within *Forman's* definition of profits.

Soon after *Forman* was decided, the court in *SEC v. Energy Group of America, Inc.*, 459 F. Supp. 1234 (S.D.N.Y. 1978), citing *Forman*, held, as did the court below, that the SEC was not entitled to a preliminary injunction as the instruments involved were not investment contracts; they did not fall in one of the two categories of cases that typified all investment contracts:

> cases where investors contributed capital to an enterprise expecting a participation in earnings resulting from the use of their funds, or as cases where tangible or intangible property was purchased by the investor in the expectation that it would appreciate in value, either because of the promoter's expertise in selecting the property or because of the promoter's managerial or entrepreneurial efforts subsequent to the purchase of the property.

Id. at 1241. The SEC did not appeal. The numerous cases cited by the SEC (SEC Petition at 15 n.4) demonstrate that this categorization was correct: *Capital Appreciation*: *United States v. Jones*, 712 F.2d 1316 (9th Cir. 1983), *cert. denied*, 464 U.S. 986 (1983); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027 (2d Cir. 1974); *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971), and *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968); *Participation in Earnings*: *Bailey v. J.W.K. Prop., Inc.*, 904 F.2d 918 (4th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989);

Albanese v. Florida Nat'l Bank, 823 F.2d 408 (11th Cir. 1987) and *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954).

Four other courts of appeals' decisions, relying upon *Forman*, have concluded, as did the court below, that the "profits" element of *Howey* is not met by a fixed payment that is not derived from capital appreciation or a share of company earnings. In all of these cases, there were contractual arrangements whereby one party was relying upon another party's performance under that contractual arrangement, but none of these cases satisfied the expectation of profits from the efforts of others test. *See Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

Speculative or non-speculative, variable or fixed, these lower courts have held that the amounts received ultimately must be either capital appreciation or earnings contingent on the use of investors' funds to be *Howey*-type profits. In sum, there has been a consistent course of federal decisions adhering to the Court's construction in *Forman* and there is no inter-circuit conflict that warrants the Court's review of the decision below.

III. The Court of Appeals Decision Does Not Depart From SEC Precedent Entitled to Deference.

Finally, review by this Court is not necessary because the court of appeals decision does not conflict with any longstanding SEC interpretation of the securities laws to which deference should be paid, and the decision has not impaired the SEC's ability to enforce these laws. As noted above, in December 2002, on the heels of the denial of its petition for rehearing and rehearing *en banc*, the SEC filed a complaint for preliminary injunctive and other relief in the Northern District of Georgia alleging securities laws violations in a case with facts indistinguishable from those in the case brought against Mr. Edwards and ETS. *See SEC v. Zanello, et. al.*, Civil Action No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002). There is no gap in the SEC's enforcement abilities. And contrary to the SEC's suggestion, the several enforcement actions it lists in its Petition would not be precluded, if otherwise appropriate, by the court of appeals ruling in this case. (SEC Petition at 25-26).[11]

The SEC's claim that its Petition is worthy because the court of appeals opinion contradicts a longstanding and consistent SEC approach to this issue also does not

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[11] *SEC v. Amtel Communications, Inc.*, 60 S.E.C. Dkt. 1753 (Nov. 7, 1995), the case which the SEC asserts involves a pay telephone business "like the one in this case" (SEC Petition at 25), resulted in the denial of the SEC's motion for a preliminary injunction in August 1995 (Civil Docket No. 95-CV-1127, S.C. Ca. 1995). This fact was omitted from the November 7, 1995, SEC "Litigation Release" cited by the SEC. Thereafter, the SEC amended its complaint and the case settled. The 2002 cases cited by the SEC involve a participation in earnings or a type of security other than an investment contract.

bear scrutiny. In 1978, the SEC's enforcement action in *SEC v. Energy Group of America*, 459 F. Supp. 1234 (S.D.N.Y. 1978), discussed above, was dismissed as a result of the failure of the SEC to meet the *Forman* profits formulation. It did not appeal. As the SEC notes (SEC Petition at 24), as *amicus* in *Reves* it took the same position it has here. Its views were rejected by the Court. *Reves*, 494 U.S. at 68 n.4. Some six years later, in 1995, the SEC investigated the ETS pay telephone program, including the marketing and leasing aspects of the business. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1282 n.1. (Pet. App. 3a n.1). During the ensuing five years, until 2000, the SEC did not take the position with ETS that it has here. The SEC has not been consistent in its application of the view expressed here.[12]

The SEC's claim to a long-standing, adjudicated interpretation applying a "profits" test less stringent than the court of appeals holding and the *Forman* profits formulation, based on the pre-*Forman* SEC opinion in *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), fares no better. In that case, the SEC did "not consider it significant" that the services provided by the promoter were not designed to create a profit, but merely were directed towards minimizing risk. *See id.* at *4. In another so-called

[12] The SEC has also presented inconsistent positions regarding another aspect of the *Howey* test, the common enterprise element, an issue in the court below. In the district court, the SEC urged "broad vertical commonality" as "black letter law." (R11-105) "[I]n its arguments in a case out of the First Circuit, the SEC concedes . . . broad vertical commonality is an inappropriate test for *Howey's* common enterprise requirement." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1286. (Pet. App. 10a). (Lay, J., concurring).

"adjudication" pointed to by the SEC, *In re Union Home Loans*, 26 S.E.C. Dkt. 1346 (Dec. 16, 1982) *available in* 1982 WL 522493, the case settled without a hearing or the presentation of evidence and the SEC announced its views in a report of investigation, not an adjudicatory opinion in a contested case.

CONCLUSION

The Petition for Writ of Certiorari should be denied.

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No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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The court of appeals dismissed the complaint of the Securities and Exchange Commission (SEC) based on the erroneous conclusion that an investment is not an "investment contract" if the promoter promises a fixed return or the investor is contractually entitled to a particular amount or rate of return. Those restrictions are unsupported by the text, background, and purposes of the securities laws, and they depart from the flexible understanding of "investment contract" consistently applied by this Court. The court of appeals' decision conflicts with decisions of other courts of appeals and the SEC's longstanding interpretation of the securities laws. The decision also opens a seemingly limitless gap in the protection those laws provide against fraud, because it allows unscrupulous promoters to circumvent the laws by describing the returns offered by investment schemes as fixed or contractually guaranteed amounts. This Court's review is therefore warranted.[1]

[1] Contrary to respondent's contention (Br. in Opp. 4 n.2), the Court must accept the truth of the allegations in the SEC's complaint. The court of appeals not only reversed the preliminary injunction, but also ordered

1. a. Respondent does not dispute that the plain meaning of "investment contract" encompasses arrangements promising fixed returns and returns specified as entitlements in a contract. See Pet. 10-11. Instead, he contends that the SEC is "mak[ing] a fortress out of the dictionary," and that a statute's plain meaning does not preclude consideration of "persuasive evidence" to the contrary "if it exists." Br. in Opp. 13 (citations omitted). But the SEC is simply starting statutory interpretation where it must—with the language of the statute. And respondent offers no "persuasive evidence" that the statute means anything other than what it says.

In particular, respondent can find no support in the background and purposes of the securities laws. As this Court explained in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298 (1946), when Congress enacted those laws, the term "investment contract" had a well-established meaning under state Blue Sky laws, and Congress adopted that meaning. The petition explains, and respondent does not dispute, that the established meaning of "investment contract" included an investment with a fixed or guaranteed return. See Pet. 11-12. That meaning comports with the purpose of the securities laws "to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990). To achieve that goal, Congress included in the definition of security certain "general descriptive designations," such as "investment contract," to ensure coverage of "[n]ovel, uncommon, or irregular devices." *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). The term "investment contract" thus promotes Congress's goal of comprehensive coverage by serving as a catch-all for "unconventional instruments that have the essential properties of a debt or equity security." *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994).

Respondent does not explain why Congress would have excluded unconventional investments with fixed or contractually guaranteed returns from the coverage of the securities laws. Instead, he argues (Br. in Opp. 10-11) that the term "investment contract" is not intended to be a catch-all. But that assertion is belied by *Joiner*'s description of the term's role. Respondent also is incorrect in contending (*id.* at 11 n.7) that the only catch-all in the definition of security is the term "any interest or instrument commonly known as a 'security.'" That term is intended to catch some items not specifically enumerated, but it encompasses only arrangements "commonly known as a 'security.'" "Investment contract," in contrast, catches arrangements that, although they may not be "commonly known" at all, "embod[y] the essential attributes" of "a security." *United Housing Found., Inc.* v. *Forman*, 421 U.S. 837, 852 (1975).[2]

b. Respondent mistakenly asserts (Br. in Opp. 6-9) that limiting investment contracts to variable return investments is required by this Court's cases. He notes (*id.* at 7-8) that the Court observed in *Howey* that the investors "share[d] in the earnings and profits" of the enterprise. 328 U.S. at 300. But the Court made that observation to demonstrate that in-

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dismissal of the complaint. The court labeled the dismissal as based on lack of subject matter jurisdiction. In reviewing a dismissal on that ground, this Court must accept the allegations as true because the court of appeals held the complaint facially insufficient, not factually unsupported. See *Turicentro, S.A.* v. *American Airlines Inc.*, 303 F.3d 293, 300 n.4 (3d Cir. 2002). If the dismissal is instead viewed as based on failure to state a claim, see *Steel Co.* v. *Citizens for a Better Env't*, 523 U.S. 83, 89 (1998) ("absence of a valid (as opposed to arguable) cause of action does not implicate subject-matter jurisdiction"), the allegations must likewise be regarded as true. See *SEC* v. *Zandford*, 535 U.S. 813, 818 (2002).

[2] Citing *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982), respondent suggests (Br. in Opp. 6 n.3) that it is unnecessary to include the ETS investments within the scope of the securities laws because they are covered by Federal Trade Commission (FTC) disclosure rules. But, unlike the bank regulations and federal deposit insurance that this Court relied on in *Marine Bank* in holding that ordinary, federally-insured bank certificates of deposit are not securities, FTC disclosure rules do not reduce risk to investors by assuring ETS's ability to pay them.

vestors were "attracted solely by the prospects of a *return* on their investment." *Ibid.* (emphasis added). The Court did not suggest that it mattered whether the return was fixed or variable. Indeed, the Court made clear that an "investment contract," as reflected in the state Blue Sky law cases, includes any "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure *income or profit* from its employment.'" *Id.* at 298 (citation omitted) (emphasis added)). Neither "income" nor "profit" is limited to a variable return. Pet. 11. Although, in paraphrasing that established definition, the Court stated that an investment contract involves the expectation of "profits," 328 U.S. at 299, nothing suggests that the Court intended to exclude fixed returns. On the contrary, the Court cited with approval several cases involving fixed returns. See Pet. 12, 16.

Respondent incorrectly contends (Br. in Opp. 8-9) that the Court subsequently excluded fixed-return instruments by statements in *Forman* and *Reves*. Describing its prior cases, the Court in *Forman* stated that, "[b]y profits, the Court has meant either capital appreciation * * * or a participation in earnings." 421 U.S. at 852. But that statement did not substitute a new definition of "investment contract" for the one adopted in *Howey* or limit investment contracts to arrangements providing variable returns. The Court's point was simply to distinguish the situation in which an investor is "'attracted solely by the prospects of a return' on his investment," which involves a security, from a situation in which "a purchaser is motivated by a desire to use or consume the item purchased," which does not involve a security. *Id.* at 852-853. Moreover, the Court made clear that "profit may be derived from the *income* yielded by an investment," *id.* at 855 (emphasis added), and that the essence of the test is whether "the investor is 'attracted solely by the prospects of a *return*' on his investment," *id.* at 852 (emphasis added). "Income" and "return" are not limited to variable yields. Pet. 18. Nor is "a participation in earnings" limited to an investment with a return *measured* by earnings. An investor

expects a participation in earnings whenever he expects that the *source* of his return will be the company's earnings.

Respondent observes (Br. in Opp. 8-9) that, in a footnote in *Reves*, the Court read *Forman* to limit "profits" to a return "keyed to the earnings of the enterprise." 494 U.S. at 68 n.4. But, as the petition explains, the issue in *Reves* was the scope of the term "note," not "investment contract," and the Court accordingly stated that "the *Howey* test is irrelevant to the issue before us today." Pet. 19 n.6 (quoting *Reves*, 494 U.S. at 68 n.4). Because the *Howey* test was not before the Court in *Reves*, the Court had no occasion (and did not purport) to alter that test. The Court merely characterized how it believed *Forman* had interpreted the test, and that characterization was mistaken.

Respondent also cannot reconcile (Br. in Opp. 14-15) his position with *Joiner*'s teaching that, in determining whether an offering is an investment contract, "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." 320 U.S. at 353. As the petition explains (at 17), and the district court found, ETS's marketing materials stressed "the 'profitability' of payphones and encouraged investors to 'watch the profits add up,'" and "ETS websites noted the 'profitable' opportunities for investors." Pet. App. 18a. After luring investors with promises of "profits," respondent cannot, consistent with *Joiner*, contend that his scheme did not involve an expectation of profits that rendered the resulting arrangements investment contracts.[3]

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[3] Although respondent asserts (Br. in Opp. 14) that the SEC inaccurately describes the marketing materials, the SEC's description mirrors the district court's findings and is supported by the record. Respondent admitted (10/12/00 Tr. 59) that he designed Exhibit 17, which contains several statements aimed at potential purchasers of payphones that tout the profitability of the phones. See Exh. 17, at 4, 7, 10. Although respondent claims that Exhibit 17 was not given to prospective investors, he admitted (10/12/00 Tr. 59) that distributors used a document "similar" to Exhibit 17 to sell the phones. Documents provided to prospective investors, as well as publicly available websites, contained statements virtually identical to those in Exhibit 17. See Exh. 15, at 8-9; Exh. 22, at 1,

c. Respondent also incorrectly argues that the court of appeals' decision did not "turn on whether the payments [investors received] were fixed or variable," Br. in Opp. 12. The court's opinion speaks for itself: The court first stated that, under *Forman*, an investment contract must involve "either a participation in earnings by the investor or capital appreciation." Pet. App. 6a. The court then stated that "capital appreciation is not at issue," and "the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings." *Id.* at 6a-7a. The court explained that, "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." *Id.* at 7a. The "fixed" nature of the return was thus plainly the linchpin of the court's decision. That is unsurprising because that is what respondent argued to the court of appeals. See Br. of Appellant 27-29.

Respondent suggests that the court of appeals distinguished between a fixed payment and "a fixed payment not derived from capital appreciation or a participation in earnings." Br. in Opp. 12. But respondent does not explain that purported distinction, show where the court of appeals made it, or explain why ETS investors did not expect that their lease payments would be derived from ETS's earnings on the telephones. Investors would have had that expectation because the marketing materials and other communications stressed the profitability of both payphones in general and ETS in particular. See Pet. 3, 4.

d. Rather than defend the court of appeals' alternative holding that the payphone interests were not investment contracts because "the investors were entitled to their lease payments under their contracts with ETS" (Pet. App. 8a), respondent dismisses (Br. in Opp. 15-16) that holding as

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5, 6; Exh. 24, at 1. Likewise, a document that respondent admits (Br. in Opp. 14 n.8) was the marketing material for the lease program also refers to "profits" for owners of payphones. See Exh. 18, at 3. Respondent is correct, however, that the petition mistakenly cites to Exhibit 14, which is not part of the record. See Br. in Opp. 14 n.8.

dicta. Alternative holdings are, however, binding precedent, including in the Eleventh Circuit. See *Richmond Screw Anchor Co.* v. *United States*, 275 U.S. 331, 340 (1928); *Aron* v. *United States*, 291 F.3d 708, 713 n.4 (11th Cir. 2002). And they are subject to review and reversal by this Court. See, *e.g.*, *Barnhart* v. *Walton*, 122 S. Ct. 1265, 1268-1269 (2002) (reversing two alternative holdings construing the Social Security Act).

2. Respondent also errs in contending (Br. in Opp. 16-20) that the decision below does not conflict with decisions of other courts of appeals. He does not even mention the cases from the First, Second, Sixth, Seventh and D.C. Circuits cited in the petition (at 22-23) in which the courts found schemes yielding fixed or contractually guaranteed returns to be investment contracts. Furthermore, he fails to reconcile the cases he does discuss with the decision here.

For example, respondent asserts (Br. in Opp. 17-18) that there is no conflict with *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978), because *Carman*'s focus was to determine if a common enterprise was present. But the opinion in *Carman* recited both the defendant's more general argument that the sales in question did not "satisfy the test set out in *Howey*" as well as his more particular argument that the sales did not satisfy the definition of a common enterprise. *Id.* at 563. And the court expressly considered and rejected an argument virtually identical to the one that the court of appeals accepted here—"that the profits expected by investors were in no way dependent upon the efforts of [the promoter] because the return was in the form of fixed interest, guaranteed by the federal government." *Ibid.* *Carman* cannot be reconciled with the decision in this case.

Respondent seeks (Br. in Opp. 18-19) to distinguish *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), on the same ground—that it decided only a common enterprise issue and not the question here. That is incorrect. The court expressly addressed and rejected "[t]he defendants' claim that the property transfer

contracts do not constitute 'investment contracts' because the investors were to receive a fixed rate of return rather than a rate dependent on the success of the investments." *Id.* at 189. In doing so, the court cited *Forman*'s description of "profits" under the *Howey* test; and it then held, in the next sentence, that "[t]he mere fact that the expected rate of return is not speculative" did not remove the contracts at issue from the category of investment contracts. *Ibid.* In any event, regardless of what aspect of the *Howey* test the *Infinity Group* court was addressing, it rejected the same argument that the court of appeals accepted here, and the two cases cannot be reconciled.[4]

Respondent also argues (Br. in Opp. 20) that the decision below is consistent with a few court of appeals decisions holding that commercial arrangements, such as loan participation agreements, are not investment contracts. Even if respondent were correct, that would only deepen the circuit conflict and strengthen the argument for review by this Court. The commercial loan cases are, however, distinguishable because they involve transactions of a primarily commercial, rather than investment, character.

3. This Court's review is also warranted because the decision below conflicts with the SEC's longstanding interpretation of the securities laws and will significantly impair its ability to protect investors. See Pet. 23-26.

Contrary to respondent's contention (Br. in Opp. 22-23), the adjudicatory decisions cited in the petition embody the SEC's view that investment contracts can have fixed or contractually guaranteed returns, and those decisions are entitled to deference under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Respondent quotes only a few phrases from the decision in *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) 92,813 (D.C. Cir. Sept. 25, 1970), but other portions of the decision quoted in the petition (at 23) make clear that the SEC there determined that a "guarantee[d]," fixed rate of return constituted the "return of profit," and that the investment at issue, which offered that fixed return, was an investment contract. *Id.* at 107-109. And contrary to respondent's contention (Br. in Opp. 23), *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), was not just a report of an investigation but was also an order of the SEC instituting and resolving administrative proceedings under Section 15(b)(4) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b)(4). The fact that the subject of the order did not contest the charges did not render the proceeding something other an adjudication entitled to *Chevron* deference. See *United States* v. *Mead Corp.*, 533 U.S. 218, 226-227 (2001) (deference is due an agency position in an "adjudication" because it is "promulgated in the exercise" of "delegated authority * * * to make rules carrying the force of law").

Although respondent asserts (Br. in Opp. 22) that the SEC's position on the question presented has not been consistent, he does not identify a single instance in which the SEC has expressed a contrary view. Respondent notes that the SEC did not appeal an adverse district court decision in 1978. *Ibid.* (citing *SEC* v. *Energy Group of Am., Inc.*, 459 F. Supp. 1234 (S.D.N.Y. 1978)). But the determination not to appeal that decision—which did not even involve the question presented here—neither reflects acquiescence in its correctness nor binds the SEC in this litigation. See *United States* v. *Mendoza*, 464 U.S. 154, 161-162 (1984). Nor does the SEC's failure to take action against respondent when it first investigated him in 1995 (see Br. in Opp. 22) preclude the SEC from taking action now. See *Utah Power & Light*

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[4] Respondent also attempts to distinguish *Infinity Group* by arguing that there, "even though fixed in percentage," the return "derived from a participation in the earnings of the trust." Br. in Opp. 18. But the investors here expected that their return would derive from ETS's earnings just as much as the investors in *Infinity Group* expected their return to derive from the trust's earnings. See p. 6, *supra*; Exh. 15, at 8 (ETS program offers "special opportunity for individuals to own payphones and earn profits from payphones").

Co. v. *United States*, 243 U.S. 389, 409 (1917); *Graham* v. *SEC*, 222 F.3d 994, 1008 & n.26 (D.C. Cir. 2000).

Finally, contrary to respondent's contention (Br. in Opp. 21), the rule adopted by the court of appeals would create a serious gap in the SEC's enforcement abilities. As the petition notes (at 25), the SEC brought more than two dozen actions involving investment contracts promising fixed or guaranteed returns in fiscal year 2002 alone. The SEC would be precluded from bringing such enforcement actions under the rule adopted by the court of appeals.[5]

* * * * *

For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

MARCH 2003

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[5] The SEC's complaint in *SEC* v. *Zanello*, C.A. No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002), does not show otherwise. That filing shows only that the SEC has decided not to forgo enforcement actions involving investment contracts offering fixed returns in the Eleventh Circuit while it seeks this Court's reversal of the erroneous decision in this case. Moreover, if respondent is correct that *Zanello* is on all fours with this case and the interests there are securities even though they are not investment contracts, then there can be no question that the court of appeals erred in this case, because it dismissed the SEC's complaint without remanding for a determination whether the SEC could proceed under another theory. See Pet. 20 n.7.

(18)

Supreme Court, U.S.
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NO. 02-1196

IN THE SUPREME COURT OF THE UNITED STATES

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

CONSOLIDATED OBJECTION BY RESPONDENT TO THE MOTIONS OF *AMICI CURIAE* FOR LEAVE TO FILE BRIEFS IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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6 11

Three motions have been filed in this case pursuant to United States Supreme Court Rule 37 seeking leave to file *amici* briefs in support of the Petition For a Writ of Certiorari. Respondent[1] withheld consent to the filing of the *amici* briefs because, as demonstrated by the attempted but unsuccessful (*see* Appendix A) filing by these same *amici* in the court of appeals in support of the Securities and Exchange Commission's (SEC) petition for rehearing and rehearing *en banc*, the views they express add heat but no light to the consideration of whether the Court should take this case. As the SEC is the primary entity charged with enforcing the federal securities laws, and it and the Solicitor General are more than adequately equipped to represent the federal and public interest here, it is unlikely the *amici* can offer original matter or expertise which would considerably assist the Court. Moreover, in attempting to demonstrate the importance of the case, each *amici*, as did the SEC (*see* Opp. at 11), mischaracterizes the issue in the case and the holding of the court of appeals.

Based on this skewed rendition of that holding, the *amici* variously complain that the court of appeals' decision permits or even actually promotes fraudulent or questionable investments that they may no longer be able to combat through their regulatory efforts and arbitrations. Despite

[1] Pursuant to Supreme Court Rule 29.6, Respondent Charles E. Edwards submits that he does not have any parent corporations or subsidiaries.

the expertise of the *amici* in interpreting their own controlling law and the undoubted value the *amici* provide to their respective constituencies, their views on the interpretation or application of *federal* law under the circumstances are not of particular value. They have also lost sight of the fact that "Congress in enacting the securities laws did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982). In short, securities regulations and securities regulators have no monopoly on combating fraud. If, in fact, the *amici* are correct that instruments not meeting the Court's "restrictive" definition of "profits" and "investment contract" are used by the unscrupulous as vehicles for fraud against consumers and the clients of the PIABA lawyers, there are numerous law enforcement actors, regulators and laws outside the securities arena to combat and deter such conduct. The views of the *amici*, grounded on the supposition that the securities laws must be broad enough to allow them to fight all fraud, will not bring new relevant matter to the attention of the Court.

The motions of *Amici Curiae* should be denied.

Respectfully submitted,

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IN THE UNITED STATES COURT OF APPEALS

FOR THE ELEVENTH CIRCUIT

FILED
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ELEVENTH CIRCUIT
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CLERK

No. 01-10107-DD

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

versus

CHARLES E. EDWARDS,

Defendant-Appellant.

On Appeal from the United States District Court for the Northern District of Georgia

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O R D E R:

The motion for leave to file an amicus curiae brief, filed by North American Securities Administrators Association, Inc., is DENIED.

The motion for leave to file an amicus curiae brief, filed by Alabama Securities Commission, is DENIED.

The motion for leave to file an amicus curiae brief, filed by Public Investors Arbitration Bar Association, is DENIED.

The motion for leave to file an amicus curiae brief, filed by the State of Florida, Department of Banking and Finance, is DENIED.

The motion for leave to file an amicus curiae brief, filed by the Secretary of State and the Commissioner of Securities of the State of Georgia, is DENIED.

CHIEF JUDGE

APPENDIX A

CERTIFICATE OF SERVICE

I, Michael K. Wolensky, a member of the Bar of this Court, hereby certify that on the 20th day of March, 2003, a copy of this CONSOLIDATED OBJECTION BY RESPONDENT TO THE MOTIONS OF *AMICI CURIAE* FOR LEAVE TO FILE BRIEFS IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI in the above-entitled case was served on all parties required to be served by U.S. Mail, first class postage prepaid, to the following:

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MOTION FILED

MAR 17 2003

No. 02-1196

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES E. EDWARDS,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI FILED BY THE SOLICITOR GENERAL OF THE UNITED STATES ON BEHALF OF THE SECURITIES AND EXCHANGE COMMISSION

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

Pursuant to Supreme Court Rules 21 and 37, the North American Securities Administrators Association, Inc. ("NASAA"), respectfully moves this Court for leave to file an *amicus curiae* brief in support of the Petition for a Writ of Certiorari ("Petition") filed by the Solicitor General on behalf of the Securities and Exchange Commission.

Parties Who Have Withheld Consent

Respondent Charles E. Edwards has withheld his consent to NASAA's filing an *amicus curiae* brief in support of the Petition.

Nature of the Movant's Interest

NASAA is the nonprofit association of the state, provincial, and territorial securities regulators in the United States and Canada, and of the Mexican national government. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.

Two of the principal goals of NASAA and its members are protecting investors from fraud and abuse in the offer and sale of securities, and promoting uniformity in the interpretation of the securities laws. The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels: (1) it strips away the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse; (2) it narrows the definition of "investment contract" under *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), creating significant loopholes for unscrupulous promoters selling other types of investments; and (3) it sets a precedent that may adversely affect the evolution of state securities law to the detriment of investors,

insofar as state courts often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in removing these threats to investor protection by supporting this Court's review of the lower court's decision.

The Eleventh Circuit's decision also undermines uniformity. It conflicts with decisions from the First, Third, and Ninth Circuits, as well as decisions from the Supreme Courts of Utah and Washington. *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001); *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000); *United States v. Carman,* 577 F.2d 556 (9th Cir. 1978); *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983); *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979). As a consequence of the Eleventh Circuit's decision, the citizens of Alabama, Florida, and Georgia face a heightened and disproportionate risk of financial exploitation because they do not receive the deterrent and remedial benefits of federal securities regulation with respect to pay phone investments and similarly structured offerings. This predicament increases the likelihood that those citizens will be the victims of fraud and abuse. NASAA therefore also has an interest in seeking to restore federal securities regulation of pay phone programs and similar investment contracts in the Eleventh Circuit to eliminate this imbalance.

Reasons for Granting the Motion

NASAA's *amicus curiae* brief should be accepted because it will assist the Court by providing it with relevant matter not likely to be advanced by the other parties to the case. *See* Sup. Ct. R. 37.1. NASAA is uniquely situated to address the deleterious impact of the appellate court's decision on public investors. For almost a century, state securities regulators have been at the forefront of the fight to protect Main Street investors from illegal and fraudulent securities offerings. NASAA, informed by its members, is intimately familiar with the toll that such schemes take on individual investors and the importance of securities regulation as a deterrent and as a remedy. Second, NASAA can speak with authority on the impact that federal decisions have on state securities law. State courts and administrative agencies often look to federal case law for guidance with respect to securities issues. The appellate court's decision, if left uncorrected, threatens to weaken state as well as federal securities law and undermine the cause of investor protection. Finally, NASAA offers legal analysis that complements the Solicitor General's arguments in support of the Petition.

In summary, NASAA and its members have a demonstrable interest in the outcome of this case and the *amicus curiae* brief will assist the Court.

Conclusion

NASAA requests that the Court grant leave to file the accompanying *amicus curiae* brief.

Respectfully submitted,

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March 17, 2003

QUESTIONS PRESENTED

1. Whether a return on an investment should be excluded from the meaning of "profits" under the *Howey* test for investment contracts merely because the promoter of the investment offers a fixed rate of return.

2. Whether a return on an investment, which is in fact wholly dependent upon the efforts of others, should nevertheless be viewed as not "derived from the efforts of others" under *Howey* merely because the promoter contractually promises or guarantees the return.

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INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of the state, provincial, and territorial securities regulators in the United States and Canada, and of the Mexican national government. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.[1]

Two of the principal goals of NASAA and its members are enhancing investor protection and increasing uniformity in the interpretation of the securities laws. The appellate court's decision undermines both of these interests.

A. Investor Protection

The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels. First, it removes the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse. Although it is to be expected that state regulation of these investments will continue unabated, eliminating the SEC's jurisdiction over such offerings will at a minimum increase the burden on state regulators and heighten the risk that investors will fall victim to these schemes. NASAA therefore has an interest in seeking the reversal of the appellate court's decision and ultimately the restoration of federal regulation of these products.

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[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary contribution to the preparation or submission of the brief.

Second, the appellate court's decision substantially narrows the definition of "investment contract" under *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). The court held that investments offering either fixed or contractually guaranteed returns do not qualify as investment contracts. This unsupported interpretation of *Howey* creates loopholes that unscrupulous promoters will undoubtedly seek to exploit in the future as they invent new ways to defraud the investing public. NASAA has an interest in helping to prevent this potentially far-reaching impact of the appellate court's decision.

Finally, the appellate court has set a precedent that may adversely affect the evolution of state securities law to the detriment of investors, insofar as state courts often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in helping to ensure that the appellate court's decision does not weaken state securities law in this way.

B. Uniformity

The Eleventh Circuit's decision also undermines uniformity in securities law. The ruling conflicts with decisions from three other federal circuit courts, as well as decisions from the highest courts of two states. As a consequence of the Eleventh Circuit's decision, the citizens of Alabama, Florida, and Georgia face a heightened risk of being victimized by pay phone promoters. Those citizens do not receive the deterrent and remedial benefits of federal securities regulation with respect to pay phone investments and similarly structured offerings. This lack of uniformity will tend to attract financial predators who have been turned away from other jurisdictions where pay phone sale and leaseback agreements are fully regulated as securities. NASAA has an interest in seeking the review of the appellate court's decision to promote fairness and to prevent any state, or group of states, from becoming a preferred haven for fraud and abuse.

SUMMARY OF THE ARGUMENT

The SEC's petition for a writ of certiorari ("Petition") should be granted, and ultimately the appellate court's decision should be reversed, for two compelling reasons. First, the court's decision, if left intact, will expose thousands of investors in the Eleventh Circuit to a heightened risk of fraud and abuse at the hands of pay phone promoters and those selling a variety of similar sale and leaseback investments no longer subject to federal regulation as securities. The decision is an unfortunate blueprint for unscrupulous promoters who will easily devise new schemes that fall outside the appellate court's narrow definition of an investment contract. Because state courts often look to federal decisions in the area of securities regulation, the appellate court's ruling can be expected to weaken state securities law over the long term if it is not reversed.

Second, the appellate court's decision is an erroneous interpretation of federal law. It conflicts with the majority of cases from federal and state courts. The decision also conflicts with the policies underlying securities law, the plain meaning and intent of the statutory provisions at issue, and the interpretation of the law by the regulatory agencies entrusted with administering it.

ARGUMENT

I. THE APPELLATE COURT'S DECISION OPENS AN ENORMOUS LOOPHOLE IN SECURITIES LAW, WHICH EXPOSES INVESTORS TO A HEIGHTENED RISK OF FRAUD AND ABUSE

By holding that the ETS pay phone investments are not securities, the court has placed investors at risk. Over the past decade, there have been widespread abuses in the marketing of pay phone schemes, and as a consequence, thousands of investors have lost money. Continued

regulation of these and similar products under both federal and state securities law is essential to limit the financial harm they cause.

A. Scope of the Problem

The pattern of abuses in the marketing of pay phone sale and leaseback programs is well documented. In March 2001, NASAA announced the results of a crackdown by securities regulators in 25 states and the District of Columbia against individuals and companies that sold illegal pay phone sale and leaseback investments.[2] Nearly 4,500 people, most of them elderly, were reported to have lost $76 million investing in these schemes. Over the years, state securities regulators across the country have initiated scores of administrative and civil injunctive actions against pay phone sale and leaseback companies and their agents, including ETS, Alpha Telcom, Phoenix Telecom, QCI, and others.[3] *See, e.g.*, cease and desist orders issued by Kansas, North Carolina, and Rhode Island against ETS, Exs. 9, 10, 11; *see also* cases discussed *infra* at Part II. A.

The SEC also has vigorously pursued enforcement actions against these illegal enterprises. Examples include this case against ETS as well as four injunctive actions in federal district court in Florida and Georgia in which the SEC sought millions of dollars in disgorgement and other relief against four pay phone companies and their agents. *SEC v. Phoenix*

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[2] NASAA, *State Securities Cops Announce Actions Against Sellers of Payphone Schemes; Losses Estimated at $76 Million So Far*, March 13, 2001, *available at* http://www.nasaa.org/nasaa/abtnasaa/display_top_story.asp?stid=108.

[3] The investments offered by these companies are essentially the same. Alpha Telcom offered investors 30% of adjusted gross revenues, but with a guaranteed minimum that equated to a 14% return. *See, e.g. In re Alpha Telcom*, No. 99-07-0220, 2002 WL 459704, *3 (Wash. Sec. Div. Mar. 13, 2002).

Telecom, No. 100-CV-1970-JTC (N.D. Ga.), 2001 WL 874314 (SEC Release No. 17089, Aug. 3, 2001); *SEC v. Linktel Communications, Inc.*, No. 100-CV-3169-WBH (N.D. Ga.), 2000 WL 1773106 (SEC Release No. 16816, Dec. 4, 2000); *SEC v. Levine*, No. 94-6898-CIV-ZLOCH (S.D. Fla.), 1994 WL 559076 (SEC Release No. 14279, Sept. 30, 1994); *SEC v. Haje*, No. 92-510-CIV-J20 (M.D. Fla.), 1993 WL 347148 (SEC Release No. 13772, Sept. 3, 1993).

The violations common to these operations include the sale of unregistered securities by unlicensed agents and fraudulent misrepresentations and omissions concerning the risks of loss, the financial condition of the enterprise, and prior disciplinary actions against the company or its principals. *See generally SEC v. Alpha Telcom, Inc.*, No. CV 01-1283 PA, 2002 WL 193093 (D. Or. Feb. 7, 2002); *SEC v. Phoenix Telecom, L.L.C.*, No. 1:00-CV-1970-JTC, 2000 WL 33956119 (N.D. Ga. Aug. 2, 2000). In short, pay phone sale and leaseback programs pose a serious risk to investors. *See Dep't of Banking & Fin. v. Mehl*, No. 02-0526, 2002 WL 31452438, at *24-25 (Fla. Div. Admin. Hgs. July 16, 2002) (Recommended Order) (multi-million dollar fine imposed against the seller of ETS pay phone investments because many investors were left in "irreversible financial ruin for the remaining years of their lives").

B. Benefits of Regulation

The SEC and state securities regulators have long viewed pay phone sale and leaseback schemes as securities and have regulated them as such. Accordingly, investors have been receiving important protections. First, those who sell securities must be tested and licensed to help ensure they have the character and fitness to accept investor funds and render investment advice. *See* 15 U.S.C. § 78o; Unif. Sec. Act of 1956 § 201 (licensing of industry participants). Second, the securities themselves must be registered so that material information about the offerings and the issuers is made

available to investors. *See* 15 U.S.C. §§ 77f, 77g, 77j; Unif. Sec. Act of 1956 § 301 (registration of securities). Third, the securities laws impose stiff civil and criminal penalties as a deterrent against violations of the licensing, registration, and anti-fraud provisions. *See* 15 U.S.C. §§ 77q, 77t, 77x, 78f, 78j, 78u; Unif. Sec. Act of 1956 §§ 101, 408-410 (civil and criminal penalties). Finally, the securities laws give regulators the authority to seek important remedial measures, including injunctions, disgorgement, and restitution, to help redress violations after they occur. *See id.* (injunctive relief and civil liabilities).[4]

With these tools at their disposal, regulators can deter violations in the first instance, halt violations in progress, and attempt to recover ill-gotten gains from those who have profited at the expense of investors. All of these provisions have played an important role in limiting the harm that illegal pay phone investment schemes and other investment contracts have inflicted on the investing public.

C. Future Impact

The appellate court's decision in this case threatens harm to investors on multiple levels by stripping away these protections. Its most immediate impact is to tie the SEC's hands in the Eleventh Circuit as to pay phone sale and leaseback programs, as well as all other investment contracts that have been structured to provide fixed or guaranteed

[4] The Uniform Securities Act of 1956 is the predominant model for state securities laws. It has been adopted by 34 states, with some individual variations. *See* Chart showing states adopting Unif. Sec. Act of 1956, *available at* www.law.cornell.edu/uniform/vol7.html#secur. Even those state that have passed their own securities laws have similar regulatory requirements and remedies.

returns.[5] While indications are that state securities regulators in Alabama, Florida, and Georgia will continue to enforce their laws vigorously against promoters of these products, sidelining the SEC will increase the burden on these state regulators and expose investors to heightened risk.

The court's decision also threatens a much broader harm by fundamentally narrowing the application of the *Howey* investment contract test. "Guaranteed" and "fixed returns" are often meaningless labels that promoters attach to their investment contracts to attract investors. Under the court's decision, these same terms—easily inserted into a contract—will also serve as a convenient shield against regulation under the securities laws. Regulators can now expect to see the emergence of a wide variety of new and bogus investment contracts specifically designed to benefit from the loophole created by the appellate court.

Finally, the court's decision will undermine state, as well as federal, securities regulation. State courts and state administrative agencies often consult federal decisions for guidance on securities issues. *See, e.g., Payable Account-ing Corp. v. McKinley*, 667 P.2d 15, 17 (Utah 1983) (states frequently rely on federal case law in interpreting state security acts); *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *2 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) ("In some instances, state and federal securities laws appear as mirror images. Both, for example, have the same definition for the term 'security.' For these reasons, in the absence of state decisional law, state courts will look to federal court decisions for guidance"); *Cf. King v. Pope*, 91 S.W.3d 314 (Tenn. 2002) (reversing Tennessee

[5] ATM machines and Internet kiosks are examples of other products that have been the subject of illegal investment schemes similar to the pay phone sale and leaseback programs. *See* NASAA, *"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

Court of Appeals, which had adopted federal rather than State commonality standard to hold pay phone contracts were not securities).

The appellate court's decision already has emboldened pay phone promoters and others to challenge prior rulings against them in state enforcement actions. These arguments are surfacing in states within the Eleventh Circuit and elsewhere. In *Iowa ex rel. Miller v. Pace,* Equity No. LA26445 (Iowa D. Ct., Warren County, Sept. 4, 2002), *appeal docketed,* No. 02-1726 (Iowa, Oct. 28, 2002), the Iowa District Court found that ETS pay phone investments were investment contracts under *Howey,* and ordered the defendant to make restitution of over $300,000 for fraud in the sale of unregistered securities. *Id.* at 16, 23-24, 27-28. The defendant has appealed the state district court's order to the Iowa Supreme Court, and is relying heavily on the Eleventh Circuit's opinion in this case for the proposition that the ETS offerings are not investment contracts, as a matter of law. *See* Appellant's Proof Br. at 28-32, *Iowa ex rel. Miller v. Pace,* No. 02-1726 (Iowa) (filed Jan. 21, 2003). The appeal is pending.

In *Garvin v. Secretary of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration), an administrative law judge with the Georgia Office of Administrative Hearings ruled that the ETS pay phone investment was a security, issued a cease and desist order against further offerings of the investment, and imposed a fine against the respondent for selling unregistered securities. The respondent has filed a petition for review in state court, relying in part on the Eleventh Circuit's opinion in this case. *See* Aff. of Charles R.T. O'Kelley, attached as Ex. B to Pet'r Br. in Support of Pet. for Judicial Review, at 7-8, *Garvin v. Sec'y of State,* No. 2002 CV 6027 (Ga. Super. Ct., Fulton County, Dec. 16, 2002). The petition for review is pending.

The appellate court's decision is also being cited in defense of investments other than pay phone sale and leaseback programs. In *In re Yucatan Resorts*, No. 2002-10-33, 2002 WL 31971658, at *1-2 (Pa. Sec. Comm'n Oct. 22, 2002) (Summary Order to Cease and Desist), the respondents were named in a cease and desist order for selling unregistered securities in the form of a vacation resort leasing program. The program offered an annual return of 9%-11%, and featured the services of a third-party agent to handle leasing of the resort units for investors. *Id.* at *1. On January 22, 2003, the respondents filed a request to vacate the order, and a motion for summary judgment in the alternative, relying in part on the appellate court's ruling. *See* Resp't Req. to Vacate Cease and Desist Order or in the Alternative, Mot. for Summ. J. and Br. in Support Thereof, at 11-14, *In re Yucatan Resorts*, No. 2002-10-33 (Pa. Sec. Comm'n) (filed Jan. 13, 2003). That request is pending.

The influence of the Eleventh Circuit's decision is not confined to courts and administrative agencies. Evidently as a direct result of the court's ruling, a bill has appeared in the Colorado legislature that would amend the definition of a security in that state to exclude leaseback arrangements "in exchange for a contractually fixed and guaranteed rate of return." *See* House Bill 1311; 1st Sess. (Colo. 2003).[6] Colorado is among the states where both state and federal regulators have taken aggressive enforcement action against pay phone promoters. *See Joseph v. Geier*, No. 01 CV 1151 (Colo. D. Ct., Denver County, Jan. 30, 2003) (order on motions for summary judgment) (Phoenix Telecom pay phone program held to be illegal investment contract); *SEC v. Quarter Call, Inc.*, No. 94Z-1227 (D.Colo.), 1996 WL 635380 (SEC Release No. 15145, Nov. 4, 1996) (action against now bankrupt pay phone company QCI, finding that

[6] *Available at* http://www.leg.state.co.us/2003a/inetcbill.nsf/fsbillcont/1777905CD8404C8187256CC50077A764?Open&file=1311_01.pdf

defendants obtained over $9 million from 520 investors in fraudulent sales of pay phone investments). The bill introduced in the state legislature is an apparent attempt to curtail securities regulation in Colorado, using the appellate court's decision as a justification.

These examples illustrate the potentially far-reaching impact that the appellate court's decision may have on securities regulation and ultimately, on public investors. To stem this tide and restore the SEC's regulatory jurisdiction to full strength, this Court should grant the SEC's Petition, and upon a review on the merits, reverse the decision of the appellate court.

II. THE APPELLATE COURT'S DECISION CONFLICTS WITH THE DECISIONS OF THIS COURT, THREE FEDERAL CIRCUIT COURTS, AND NUMEROUS STATE COURTS

The appellate court held that because the returns promised by ETS were at a fixed rate, they could not be classified as a participation in earnings, and therefore could not be considered profits for purposes of defining an "investment contract" under *Howey* and *Forman*. *See SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284-85. As an alternative basis for its decision, the court also held that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *Id.* at 1285. The appellate court's decision conflicts with the precedents of this Court, three federal circuit courts, and numerous state courts. The appellate court's decision also conflicts with traditional statutory analysis, the policies underlying the securities laws, and the interpretations of the federal and state administrative agencies responsible for securities regulation.

A. The Appellate Court's Narrow Interpretation of Profits

1. Conflict with Federal and State Court Decisions

Under *Howey* and a venerable line of Supreme Court cases, courts are to interpret the definition of "investment contract" broadly and must seek to effectuate the remedial purpose of federal securities law, which is investor protection. *See Howey*, 328 U.S. at 299, 301; s*ee also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The appellate court's decision conflicts with these fundamental principles. The court seized upon a restrictive interpretation of *Forman* and adopted a "limited meaning" of the word "profits." *See* 300 F.3d at 1284. The court furthermore dismissed an enforcement action against an illegal enterprise that defrauded thousands of investors, a result at odds with the remedial purpose of the federal securities laws.

The appellate court's decision also conflicts with this Court's specific formulations of the "profits" test. In *Howey,* the Court chose a variety of terms to describe an investor's expectations under an investment contract, including "income," "profit," and "financial returns." *See Howey,* 328 U.S. at 298, 300. All of these words encompass fixed as well as variable returns. The Court confirmed the broad meaning of these terms by relying on state cases involving investment contracts with fixed returns. *See People v. White*, 12 P.2d 1078, 1079, 1081 (Cal. Dist. Ct. App. 1932) (investment contract found where promoter offered a $7500 return on $5000 invested in enterprise trading trust deeds, bankrupt stocks, and foreclosure instruments); *Stevens v. Liberty Packing Corp.*, 161 A. 193, 194, 195 (N.J. Ch. 1932) (investment contract found where promoter offered $1 per offspring in breeding scheme involving sale and leaseback of rabbits). Removing any doubt on this issue, the Court in *Howey* declared: "It is immaterial whether the enterprise is

speculative or non-speculative . . . . The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *See Howey*, 328 U.S. at 301.

The *Forman* case is not to the contrary. Once again, the Court's choice of words belies the appellate court's narrow interpretation. In *Forman,* the Court repeatedly used terminology that is consistent with fixed as well as variable returns: "income," "profits," and "financial returns." *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-53 (1975). The Court's reference to "participation in earnings" was not an attempt to graft technical distinctions—such as fixed versus variable rates—onto investment contract analysis, but to differentiate the expectations of an investor from those of someone seeking to use or consume a commodity. *See Forman,* 421 U.S. at 852-53. The holding in *Forman* rested squarely on this point, not on notions of fixed or variable returns: "What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use." *Id.* at 858. On this basis, the Court held that stock in a non-profit housing cooperative was not an investment contract. *Id.* at 853. By contrast, of course, investors in the ETS program were motivated by the lure of profits, not by a desire to acquire telephones.[7]

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[7] Even if "participation in earnings" were the litmus test for investment contracts, the appellate court's decision would still be incorrect because receiving fixed returns does not preclude one from participating in earnings. To the extent ETS investors actually received fixed monthly yields from pay phone operations, they would have been *participating* in earnings because their returns would have been *paid* from earnings. The appellate court conceded as much: "Of course, the funds generated by the pay phones helped ETS meet its obligations." 300 F.3d at 1285.

The court's decision also conflicts with Supreme Court cases holding that the nature of an investment offering may be determined by the representations that promoters have used to sell it to the public. *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943) (oil leases combined with test drilling services). Until the appellate court issued its decision in this case, the Eleventh Circuit followed this approach. *See SEC v. Unique Financial Concepts*, 196 F.3d 1195 (11th Cir. 1999) (sham investment in foreign currency options evaluated under *Howey* in terms of the promoter's representations). Respondent Edwards quite clearly used the lure of "profits" to sell his pay phone investments. *See* Ex. 14, at 1, 2; Ex. 15. at 5, 7, 8, 9; Ex. 17, at 4, 5, 8, 9, 10, 11; Ex. 22, at 1, 5.

The appellate court's interpretation of profits also conflicts with decisions issued in at least three other federal circuits. In *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001), the promoters of an investment trust argued that shares in their program were not investment contracts because they featured a fixed rate of return rather than a rate dependent upon the success of the investments. The Third Circuit flatly rejected this defense, holding that "the definition of a security does not turn on whether the investor receives a variable or fixed rate of return." *Id.* at 189.

In *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001), the First Circuit had no difficulty finding an "expectation of profits" where a promoter of "virtual companies" on the internet "flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% . . . ." *Id.* at 54; s*ee also United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978) (fixed interest guaranteed by federal government was nevertheless derived

from efforts of others due to investors' passive role and continuing dependence upon promoter's sound management and solvency).

The appellate court's decision also conflicts with decisions issued by two state supreme courts.[8] In *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983), investors contributed cash and other assets to fund a payroll management business, for which the company promised to pay fixed monthly interest. *Id.* at 16-17. The Supreme Court of Utah held that the arrangement was an investment contract under *Howey* notwithstanding the fixed rate of return:

> The crucial factor is not whether the rate of return is fixed, but whether the "investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise". . . . That the investors receive a fixed rate of return does not make this scheme any less an investment contract. The money to pay off the investors is still generated by PAC, and the risk of loss still depends on PAC's managerial skills.

Id. at 19, 21 (quoting *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 829 n.5 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir. 1983), *cert. denied*, 464 U.S. 852 (1983)).

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[8] As a threshold matter, state court decisions are relevant in this case for two reasons. The term "investment contract" originated in state blue sky laws during the early 1900's, and it was interpreted extensively by state courts before Congress enacted the federal securities laws. *See Howey*, 328 U.S. at 298. For this reason, the Court in *Howey* expressly adopted state judicial interpretations of the term "investment contract" as a guide to its meaning under federal law. *Id.* Today, virtually every state securities law in the country includes a definition of the term "security" that closely parallels the federal definition and that specifically includes "investment contracts." Therefore, modern state court decisions, as well as the early state cases that helped establish the investment contract definition, continue to serve as a guide to the meaning of the term.

In *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979), the plaintiff invested in a retail appliance leasing business in return for 12% fixed interest payable monthly. *Id.* at 1208. The Supreme Court of Washington held that the arrangement was an investment contract under *Howey*, because even though the investor's profit may have been constant, she was still subject to the risk of loss of her entire investment if the management failed to keep the company profitable. *Id.* at 1210.

The appellate court's opinion conflicts with other state cases. Two of the state precedents that the Court relied upon in *Howey* for defining investment contracts involved fixed returns. *See People v. White*, 12 P.2d 1078; *Stevens v. Liberty Packing Corp.*, 161 A. 193, cited *supra*. More recently, trial courts in Colorado and Iowa have held that pay phone sale and leaseback investments, including the ETS contract and a similar version offered by Phoenix Telecom, were investment contracts. *See Joseph v. Geier*, No. 01 CV 1151, at 2 (Colo. D. Ct., Denver County, Jan. 30, 2003) (order on motions for summary judgment) (a fixed rate of return does not take an investment contract out of the definition of a security); *Iowa ex rel. Miller v. Pace*, Equity No. LA26445, at 17 (Iowa D. Ct., Warren County, Sept. 4, 2002), *appeal docketed*, No. 02-1726 (Iowa Oct. 28, 2002) (irrelevant that inducements leading an investor to risk his initial investment are founded on promises of fixed returns rather than a share of profits.)[9]

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[9] Since 1939, a minority line of cases has emerged holding that payment of a fixed fee such as interest does not meet the profits test. *See* 12 Joseph C. Long, Blue Sky Law § 2.58 (2002) and cases cited therein. However, these decisions have been viewed as "defective" for two reasons. First, the distinction between dividends and interest is often arbitrary and subject to the control of the promoter. Second, the real focus of the *Howey* profits test is on the motivation of the investor, not the specific nature of the profits or losses of the enterprise. *Id.*

These conflicts between the Eleventh Circuit's decision and the decisions of this Court, the federal circuits, and the state courts provide a compelling basis, within the meaning of Rule 10, Sup. Ct. R. 10, for granting the Petition.

2. Other Considerations

A plain meaning analysis of the term "investment contract" provides further evidence that the appellate court's opinion is incorrect and should be reviewed by this Court. The words "investment contract" actually encompass, rather than exclude, fixed rate investments. The dictionary definition of the term "investment"—in 1934 as well as today—includes the core concept of investing money for "income or profit." *See Websters New International Dictionary* 1306 (1934); *Websters Third New International Dictionary* 1190 (1993). "Income," in turn, refers to a gain or recurrent benefit usually measured in terms of money, and it clearly encompasses regular and fixed payments, as well as variable amounts. *See Websters New International Dictionary, supra,* at 1258; *Websters Third New International Dictionary, supra,* at 1143. The appellate court's restrictive interpretation of the term "profits" is inconsistent with the plain meaning of the terminology chosen by Congress.

Legislative intent supports the point. This Court has repeatedly observed that Congress intended to define the term "security" broadly in order to eliminate serious abuses in the securities market. *See, e.g. Reves v. Ernst & Young,* 494 U.S. 56, 60 (1990); *United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 847-48 (1975). Congress added the term "investment contract" as a catchall provision to ensure that the statute would cover not just the items specifically listed, such as stocks and bonds, but "virtually any instrument that might be sold as an investment." *See Reves,* 494 U.S. at 61; *SEC v. C. M. Joiner Leasing Corp.,* 320 U.S. 344, 351 (1943). Of course, many of the instruments enumerated in the definition

of a security involve fixed returns, promises, and even guarantees. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10). As a catchall term, the reference to "investment contract" deserves an interpretation broad enough to include these traditional characteristics of securities, along with features outside the mainstream. *See C. M. Joiner Leasing,* 320 U.S. at 351 ("We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included in any of these definitions, as a matter of law, if on their face they answer to the name or description").

The appellate court's decision also conflicts with the interpretation of securities law that both federal and state securities regulators have applied for years. Under the principle of deference to administrative interpretation, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *See Chevron, U.S.A, Inc. v. Natural Res. Def. Council,* 104 S. Ct. 2778, 2782 (1984). The SEC's position that investment contracts include fixed and guaranteed returns is reflected in the enforcement actions described above, *supra* at Part I.A, and in the authorities cited by the Solicitor General, *see* Petition at 23-26.

State securities regulators also have brought innumerable enforcement actions against ETS, their sales agents, and other companies offering similar sale and leaseback programs. *See* actions discussed *supra* at Part I.A. So far, state administrative law judges and commissions have rejected arguments that fixed or guaranteed returns put an investment beyond the reach of *Howey. See, e.g., Stigall v. Sec'y of State,* No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002); *Garvin v. Sec'y of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration) ("An offeror may not avoid registration of a security in Georgia merely by

establishing a fixed rate of return on the investment"). *But cf. In re Rahaim*, No. E-2000-22, at 5 (Sec'y of the Commonw. of Mass., Sec. Div., July 11, 2000) (Memorandum and Order).[10] These interpretations of the securities laws by the regulatory authorities tasked with administering them support review of the appellate court's decision.

B. The Appellate Court's Unique Interpretation of the Efforts of Others

As an alternative basis for its decision, the appellate court ruled that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *See* 300 F.3d at 1285. This decision cannot be reconciled with decisions from the federal circuit courts or the policies underlying the securities laws.

1. Conflict With Federal Court Decisions

Decisions from other federal circuits have established that the appropriate focus of the third *Howey* element is not on whether returns are contractually guaranteed, but on "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See, e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

Prior to this case, the Eleventh Circuit followed this approach. In *Albanese v. Florida National Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987), a case involving an ice machine sale and leaseback scheme, the court found that the promoters retained managerial control over the ice machines and on this basis held that the "efforts of others" test was

[10] The *Rahaim* decision held that the ETS pay phone contract was not an investment contract, on commonality grounds. The case did not rest on the "profits" or "efforts of others" elements of *Howey*. *See Rahaim*, at 4, 9.

satisfied. *Id.* at 410-412. With respect to the third prong of *Howey*, the court stated that "Under the precedent of this circuit, the crucial inquiry is the amount of control that the investors retain under their written agreements." *Id.* at 410.

The appellate court's decision also conflicts directly with the Ninth Circuit's decision in *United States v. Carman*, 577 F.2d 556, 563 (9th Cir. 1978). There the defendants sold fixed rate, federally guaranteed packages of student loans, along with service contracts. *Id.* at 560, 563-64. Against charges of securities fraud, the defendants argued that their offerings were not securities because returns were in the form of guaranteed fixed interest, which did not depend upon the promoters' efforts. *Id.* at 563. The Ninth Circuit rejected this argument, observing that the investors had a passive role and were in fact dependent upon the "sound management and continued solvency" of the promoter to maintain the guarantee in place and absorb potential refund liability under the notes. *Id.* Similarly in this case, ETS investors were passive, and they relied upon ETS's continuing efforts to manage the pay phones—or entice additional investors—to provide the returns.

2. Other Considerations

The rationale underlying these cases is clear. The securities laws were intended to provide investors with certain safeguards because they put their funds at risk. The economic reality is that promises and guarantees of returns—even from a legitimate business enterprise—do not eliminate investor risk. Promises can be broken and companies can go bankrupt, as ETS did in this case. Very often, in fact, assurances of guaranteed returns are part of a promoter's sales pitch, not a genuine risk-reducing feature of the investment. Accordingly, investors need the protections of the securities laws whether or not their investments are nominally "guaranteed" or promised to them as the benefit of their bargain, just as they require those same protections

whether or not their returns are fixed. *Cf. Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (in the analysis of investment contracts, "form is to be disregarded over substance" and the emphasis should be on "economic reality").

CONCLUSION

For the reasons set forth above, the SEC's petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 17, 2003

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No. 02-1196

In The Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER
v.
CHARLES E. EDWARDS, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE*
and
BRIEF *AMICI CURIAE* IN SUPPORT OF PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE* IN SUPPORT OF PETITIONER[1]

The *Amici Curiae*, the State of Florida Department of Financial Services Office of Financial Institutions and Securities Regulation, the State of

[1] No counsel for a party authored this petition in whole or in part, and no person or entity other than *amici curiae* made a monetary contribution to the preparation or submission of this petition.

Alabama Securities Commission, and the State of Colorado Department of Regulatory Agencies Division of Securities ("*Amici Curiae*"), through undersigned counsel, respectfully move this Court, pursuant to Rule 37.2(b) of the Rules of the Supreme Court, for leave to file the accompanying brief *amici curiae* in support of the Petitioner, the Securities and Exchange Commission.

The Petitioner has granted its permission for the *Amici Curiae* to file the accompanying brief; however, the Respondent declined, via telephone, to grant its permission.

The *Amici Curiae* are extremely concerned with the judgment issued by the United States Court of Appeals for the Eleventh Circuit in this case, and take this opportunity to extend their support to the Securities and Exchange Commission ("SEC" or "Commission") in its petition for certiorari. The Eleventh Circuit's interpretation of the definition of an "investment contract," as set forth in its judgment, not only varies from previous interpretations of the definition but, if allowed to stand, establishes a significant loophole for unscrupulous investment promoters to devise programs that will avoid regulation by the SEC and, in large part, the states which have frequently passed legislation to mirror federal law and federal interpretation of an investment contract. The *Amici Curiae* submit this brief to bring to the Court's attention the importance of the decision below and its potential to severely hinder their efforts to protect the investing public from fraudulent or questionable investment schemes.

The Eleventh Circuit's decision conflicts with existing federal and case law and, thus, adds confusion to the complex arena of securities regulation for both the SEC and the states.

For the foregoing reasons, the *Amici Curiae* move this Court for leave to file the accompanying brief *amici curiae* in support of Petitioner.

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I

QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definitions of "security" in Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(1)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

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INTERESTS OF *AMICI CURIAE*

The interests of the *Amici Curiae* are set forth in the foregoing Motion of The *Amici Curiae* for Leave to File Brief *Amici Curiae* in Support of Petitioner.

SUMMARY OF ARGUMENT

The regulation of the investment, or securities, industry began with the states which independently developed a broad base of statutory and case law designed to protect the public from unscrupulous investment promoters. These laws became known as "Blue Sky Laws" in recognition of their attempt to protect investors from participating in investments that were of no more "real value" than owning a piece of the sky. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed.1244 (1946)

As our nation matured and investment opportunities and schemes proliferated, Congress, in the wake of the 1929 stock market crash, passed the Securities Act of 1933 and, shortly thereafter, the Securities Exchange Act of 1934 (the "Acts"). These laws, designed to oversee and regulate the securities industry on a national level, supplemented and complimented the existing state system of blue sky laws. The net effect was a regulatory system that protects both the national securities markets, overseen by the Securities and Exchange Commission ("SEC"), and the more centralized, local securities markets, regulated by each state individually.

When faced with interpreting the "new" Acts, this Court, in recognition of the strength and wisdom of the states' experience, turned to the state court decisions,

and used those decisions as a springboard for developing the federal law. Recognizing the benefit of establishing consistency in the regulation of securities, the states began to look to the developing federal law for guidance in interpreting and applying their state laws. In so doing the state and federal systems developed bodies of case law which, in large part, unite to provide a strong regulatory base for protecting the investing public. However, as with most things regulated, investment promoters developed investment products which did not fit neatly into the investment categories defined by statute.

The Eleventh Circuit's decision in this case is an inadequate judicial response to a promoter's investment scheme. While the states will continue to regulate the securities industry on their local levels and the SEC will continue to regulate the industry on a national level, the effectiveness of the interlocking systems will be lessened without the benefit of this Court's wisdom and guidance.

I. The Eleventh Circuit's decision narrowed the *Howey* test

In applying the *Howey* test, the Eleventh Circuit relied upon a restatement of the test which omitted crucial language that appeared in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed.1244 (1946). When this Court issued its decision in *Howey*, it adopted an existing definition of "investment contract" the Minnesota Supreme Court articulated in *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937 (Minn. 1920): "[a]n investment contract thus came to mean a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment." *Id.* at 1102. When this Court applied

the existing definition of "investment contract" to the facts of *Howey* it referred to the investment as returning "profit" to the investor, but did not mention the word "income." In relying on the *Howey* decision, the Eleventh Circuit turned to the streamlined language rather than the original definition. In so doing, the Eleventh Circuit eliminated the concept of income and focused on "net profit" - a concept which was not adopted by this Court in *Howey*.

II. Speculative Versus Non-speculative Investments

This Court in *Howey* specifically stated that, in determining whether an investment product meets the definition of an "investment contract," it is immaterial whether the investment product was speculative or non-speculative and whether the investment involved an asset of intrinsic value. However, the Eleventh Circuit repeated the same mistake as the Fifth Circuit Court of Appeals made 56 years earlier in *Securities & Exchange Commission v. Howey*, 151 F.2d 714 (5th Cir. 1945). In the case at bar, the Eleventh Circuit ignored this Court's determination that the speculative nature of the investment was immaterial when determining whether an investment product fitted within the definition of an "investment contract." The eleventh Circuit mistakenly injected "risk" and the speculative nature of the investment as the determining characteristic of jurisdiction.

III. Form Over Substance

By concentrating its analysis on the sale-leaseback agreements entered into between ETS and the investors, the Eleventh Circuit elevated form over substance. The Eleventh Circuit mistakenly allowed the

lease agreement, which purported to provide a fixed monthly return and a guaranteed "re"-purchase price for the payphone, to inoculate the entire transaction from be an "investment contract." In so doing, the Eleventh Circuit ignored that the lease agreement and its promises to pay and to repurchase were merely false promises within a larger scheme of false promises designed to dupe investors. *See generally, Dassero v. Edwards*, 190 F.Supp.2d 544 (W.D.N.Y. 2002); *State v. Justin*, 237 F.Supp.2d 368 (W.D.N.Y. 2002); *Hornor, Townsend & Kent, Inc. v. Hamilton*, 218 F.Supp.2d 1369 (N.D.Ga. 2002) (each case provides a brief discussion of the ETS Payphone, Inc. Investment program)

ARGUMENT

I. The Eleventh Circuit's decision narrowed the *Howey* test

The Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Acts") are remedial legislation passed by Congress to protect investors from unscrupulous investment promoters and as such require broad and liberal construction. *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir. 1974) citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946); *Techerepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967). In passing the Acts, Congress joined the states in their efforts to protect the investing public from fraudulent investment programs. As this Court said in *United Housing Foundation v. Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975),

> The primary purpose of the Securities Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors. Because securities transactions are economic in character congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.

Id. at 849, 95 S.Ct. at 2059, 44 L.Ed.2d at 630.[1] While the federal securities laws were enacted with a focus toward the broad purpose of protecting the national securities market, the individual states' securities laws had a more localized focus.

As the federal body of law developed through the interpretation and application of the Acts, the state law concept of an "investment contract" was adopted and articulated in the federal courts. The states had long ago established a framework for determining whether a

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[1] As the Court of Appeals in *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 , n. 1, (9th Cir. 1976), "The 'capital market' referred to by the Court includes debt as well as equity instruments". *See Investment Company Institute v. Camp*, 401 U.S. 617, 635, 91 S.Ct. 1091, 1101, 28 L.Ed.2d 360, 380 (1971), quoted infra note 2 of concurring opinion.

transaction qualified as an investment contract. *See, Gopher Tire & Rubber Co.*, 177 N.W. at 938. That framework was adopted and succinctly formalized by the United States Supreme Court in *Howey*. While embracing the states' analysis of what constitutes an "investment contract," the lower federal courts have glossed *Howey* into a three-prong test:

1. An investment of money;
2. The existence of a common enterprise; and
3. An expectation of profits to be derived solely from the efforts of another.

The abbreviated language utilized by the lower courts in the *Howey* test has, over time, become ingrained in federal and state case law.[2] However, the Court's actual words in *Howey* reveal that the concise, three-prong test omitted what becomes critical language in ETS and similar scenarios. The *Howey* Court acknowledged, and preserved, the Minnesota Supreme Court's definition of an "investment contract" stating:

> The term 'investment contract' is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state 'blue sky' laws in existence prior to the adoption of the federal statute and, although the term was

[2] *Brown v. Rairigh*, 363 So.2d 590 (Fla. 4th DCA, 1978); *See also, Payable Accounting Corporation v. McKinley*, 667 P.2d 15 (Utah 1983); *Sauer v. Hays*, 539 P. 2d 1343 (Colo. Ct. App. 1975); *Ex parte State of Alabama* (Re: *Burke v. State)*, 385 So. 2d 648 (Ala. 1980).

> also undefined in state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for 'the placing of capital or laying out of money in a way intended to *secure income* or profit for its employment.' *Gopher Tire & Rubber Co.*, supra at 938.

Howey, 328 U.S. at 298, 66 S.Ct. 1102 (emphasis added). Although *Howey* is viewed as the quintessential authority on what constitutes an investment contract, the Supreme Court itself acknowledged that it was simply borrowing a concept and definition already established through state blue sky cases and applying it to the specific facts in *Howey*. As shown above, and adopted by this Court, the state definition of "investment contract" included the anticipated receipt of "income *or* profit." *Id.* (Emphasis added.) This adoption is critical for understanding *Howey*, because the terms "income" and "profit" are not always synonymous. Rather, "income" is defined as "money, etc. received in a given period, as wages, rent, interest, etc." where "profit" is defined as "financial gain; esp. the sum remaining after deducting costs." *Webster's New World Dictionary* (1990). In other words, "income" is a broader concept than "profit." "Income" encompasses the receipt of revenue. *All* revenue qualifies as income. Whereas, "profit" usually represents a value remaining after some portion, or all, expenses have been deducted from the revenue received. In mathematical terms,

"profit" can be described as a subset of "income" - a portion of the revenue received. Regardless, the court did not exclude income, but rather said "income or profit," implying the broadest use of those terms.

This Court spoke solely in terms of "profit" only in *Howey* because, as a review of the facts of that case reveals, *Howey* involved an investment plan which offered the investors a share of the *profits* realized from the sale of the fruit as opposed to a stream of "income," as was the case in ETS. That is, the plan that was marketed in *Howey* expressly provided that the investors would receive a portion of the revenue that was left *after* expenses - or, as the *Howey* court stated "an allocation of the net profits." *Howey*, 328 U.S. at 298, 66 S.Ct. at 1102.

Citing to *Forman*, the Eleventh Circuit reasoned:

> In *Forman*, the Court made clear that the word "profits" has a limited meaning under federal securities law. Profits, in that context, require either a participation in earnings by the investor or capital appreciation. *See id.* at 852, 95 S.Ct. 2051 ("By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . .")

Securities and Exchange Commission v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002). However, the *Forman* court did not state that the "earnings" had to come from the "profits" of the investment program.

Black's Law Dictionary defines "earnings" as income. *Black's Law Dictionary* (5th ed. 1979). "Earnings" can also be described as the income generated by the use of assets. The Eleventh Circuit, however, failed to acknowledge or recognize the common understanding of term "profit," but rather chose to interpret "earnings" and "profit" in the highly technical, economic sense of return on risk in "net" earnings or profit, i.e. the revenue remaining after expenses are deducted. Of course, under the Eleventh Circuit's interpretation, the monthly payments to the investors would be a cost of operation to ETS. Mistakenly, the Eleventh Circuit applied the narrowest possible interpretation to the terms "profits" and "earnings," i.e. "net" earnings or "net" profits.

Under *Howey*, the ETS investors were, indeed, participating in the "profits" or "earnings" of the investment program since the lease payments could only be made if ETS's ponzi scheme continued with the sale of pay phones. Even if there were no ponzi scheme, ETS's ability to make the lease payments was dependent on the success of ETS's generating income through the management and placement of the pay telephones.

Further, the Eleventh Circuit's mistakenly restrictive interpretation imports a foreign risk-based analysis into the law and flies in the face of the well settled concept that legislation is to be construed so as to give meaning to the legislative policy behind it. This Court, in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943), taught:

> Some rules of statutory construction come down to us from sources that were hostile toward the legislative process itself and thought it generally wise to restrict the operation of an act to its

> narrowest permissible compass. However well these rules may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

Id. at 350, 64 S.Ct. at 123 (footnotes omitted). *See also, El Khadem*, 494 F.2d at 1227 (9th Cir. 1974).

The Eleventh Circuit mistakenly held that the fixed income feature of the ETS program prevented the sale and leaseback of the pay phones from being classified as a security because the investors had no expectation of receiving "profits" derived solely through the efforts of others but, rather were entitled to a risk-free fixed return, or income, guaranteed by contract. The Eleventh Circuit relied on a narrow gloss of an "investment contract" and failed to consider the actual text of the definition, as set forth in *Howey*. *Howey* adopted Minnesota's inclusive language in referring to "the placing of capital or laying out of money in a way intended to *secure income* or profit." *Howey*, 328 U.S. at 298, 66 S.Ct. at 1102 (emphasis added).

This Supreme Court's position that an "investment contract" could include an investment with a payoff that is stable is further illustrated by this Court's response to the Appellate Court's reasoning in *Securities & Exchange Commission v. Howey*, 151 F.2d 714 (5th Cir. 1945), where this Court stated:

> We reject the suggestion of the Circuit Court of Appeals, 151 F.2d at 717, that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, *it is immaterial whether the enterprise is speculative or non-speculative* or whether there is a sale of property with or without intrinsic value.

Howey, 328 U.S. at 301, 66 S.Ct. at 1104 (emphasis added). In 1946, this Court rejected the same narrow risk-based analysis that the Eleventh Circuit adopted in its 2002 ETS decision 56 years later.

II. Speculative Versus Non-speculative Investments

"Speculative," in the common use of the word, refers to any risky venture (as buying or selling certain stocks, etc.) with the chance of making huge profits. *Webster's New World Dictionary* (1990). A *non-*speculative enterprise, then, would encompass a venture which is not risky and does not, necessarily, hold the promise of huge profits.

As the Supreme Court of Utah noted in *Payable Accounting*, quoting from *El Khadem*:

> It is true that unlike the situation in *Howey*, the financial gain for Ms. El Khadem did not very

> from year to year depending on the skill with which Nationwide managed her collateral. Rather, only the risk of loss varied with Nationwide's management skills. But this distinction . . . is without significance . . .. The distinction is precisely that between a common stock and a corporate bond, yet a corporate bond is not for that reason excluded from the definition of a security.

Payable Accounting, 667 P.2d at 19, quoting *El Khadem*, 494 F.2d at 1229. *See also, SEC v. Infinity Group Co.*, 212 F.3d 180, 191 (3rd Cir. 2000) ("[T]he investors' beads were strung upon the gossamer guarantee of seemingly impossibly high returns at no risk. The fact that TIGC promised a "fixed rate of return" based upon the amount invested is irrelevant."); *Becks v. Emery-Richardson, Inc.*, 1990 WL 303548 (S.D. Fla. 1990) ("offer of a fixed monthly return and promotion of a tax benefit constituted at least a promise of financial gain or 'profit' resulting solely from the efforts of others.")

In stark contrast, the Eleventh Circuit ignored the *Howey* concept of "income or profit," instead utilizing a wholly inappropriate standard for profit, equating it to a risk-based, "speculative" return on capital. The Eleventh Circuit ignored this Court's fundamental teachings that any return, speculative or non-speculative, "income or profit," in an enterprise is sufficient to satisfy the *Howey* test. Clearly, an investment which provides for a fixed monthly payment, even one "guaranteed" by the promoter's contract with the illusory right to sue, qualifies as an investment contract.

III. Form Over Substance

As the Utah Supreme Court said in *Payable Accounting Corporation*, quoting *LTV Federal Credit Union v. UMIC Government Securities, Inc.*, 523 F. Supp. 819, 829, n. 5 (N.D. Tex. 1981), "[t]he crucial factor is not whether the rate of return is fixed, but whether the 'investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise'." *Payable Accounting Corporation*, 667 P.2d at 19.

In *People v. Milne*, 690 P.2d 829 (Colo. 1984), the Colorado Supreme Court was faced with an investment scheme involving "investment notes" which provided for a quarterly fixed-rate interest payment and a five-year maturity date along with a provision permitting the investors to accelerate the maturity date with 60 days written notice. Utilizing the *Howey* test to determine that an investment contract was involved, the Colorado Supreme Court reasoned:

> The [investment note] holders invested with the primary purpose of receiving profits.
>
> The holders also invested in a "common enterprise" insofar as *the return on their money paid to VLA was dependent upon the continuing operation and success of the business. Should the corporation become insolvent or sustain substantial financial losses, as was the case, the source of the fund from which payment was to be made would be lost.* Moreover, the investors' expectation of profit derived solely from the managerial efforts of others. Payment of the promised return

> depended solely upon the ability of the defendant and other VLA officials to successfully manage and operate the corporation. The investors had no ability to control or manage the funds they invested or otherwise ensure that their promised return was actually paid.

Milne, 690 P.2d at 833 (citation omitted; emphasis added).

This truth was implicitly admitted by ETS in its bankruptcy case wherein ETS pled, in a declaratory judgment class action, that the lease agreements between ETS and the investors *were not properly characterized as "true leases"* and, therefore did not give the investors a security interest in the pay phones:

> The Class member [investors] paid, directly or indirectly, for public payphones by entering into form sale-leaseback agreements with Debtors [ETS] (the "Agreements"). A true and complete copy of a representative Agreement is attached hereto as Exhibit A. Pursuant to the Agreements, Debtors maintained possession of the phones and managed and operated the phones on behalf of the members of the Class. The Class members retained little, if any, control over the payphones. The Class members did not participate in the operation of the payphones. Debtors paid the Class a stream of income in monthly installments.

Second Amended Complaint For Declaratory Judgment, in *In Re PSA, Inc., a Delaware corporation, and Affiliates, Debtors; PSA, Inc, and ETS Payphones, Inc. v. Stow*, in the United States Bankruptcy Court for the District of Delaware, case no. 00-3570 (EIK), Adversary Proceeding No. A-01-4711, p. 4, ¶ 9. The net result of ETS's bankruptcy pleading was to characterize the investors as unsecured creditors, enabling ETS to "claim" the pay phones as assets. By claiming the pay phones as assets, ETS was, in effect, "given" significant assets to be used by the reorganized company in which *the pay phone investors were given stock. See, First Amended Joint Reorganization Plan Submitted by the Debtors and the Official Committee of Unsecured Creditors, In Re: PSA, Inc., ETS Payphones Inc., ETS Vending, Inc., Et Al.*, United States Bankruptcy Court for the District of Delaware, Case No. 00-3570 (JCA).[3]

As this Court acknowledged in *Techerepnin*, 389 U.S. at 336, 88 S.Ct. at 553 (1967), "form should be disregarded for substance and the emphasis should be on economic reality." For the Eleventh Circuit form was paramount. Simply because a lease with ostensibly fixed payment was given to investors, the Court ignored the evidence of record that ETS could not generate funds absent the ponzi scheme sale of more telephones, could not repurchase the telephone, and could not in

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[3] A copy of this document is set forth in the *Lodging of Amici Curiae* as an attachment to the *Findings of Fact, Conclusions of Law and Order Confirming The Joint Reorganization Plan Of PSA, Inc., ETS Payphones, Inc. And ETS Vending, Inc., Et Al.*, in the case of *In Re: PSA, Inc., ETS Payphones, Inc., ETS Vending, Inc. Et Al.*, in the United States Bankruptcy Court for the District of Delaware, Case No. 00-3570.

reality make the lease payment. In substance the lease was an empty promise and merely another fraudulent misrepresentation to induce investors into purchasing the investment contracts, the pay telephone-management package. The "lease" was as real as the promise made to Florida investors that the investment contract was as safe as an annuity.

In its wisdom, this Court, in *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 689, 105 S.Ct. 2297, 2303, 85 L.Ed.2d. 692 (1985), acknowledged that "*SEC v. W.J. Howey Co., supra*, further elucidated the *Joiner* Court's suggestion that an unusual instrument could be considered a 'security' if the circumstances of the transaction so dictated." In reviewing the ETS investment scenario, the Eleventh Circuit Panel myopically focused on the leaseback agreement between ETS and the investor rather than viewing the transaction as a whole. According to several Florida ETS investors, their investment advisors encouraged them to withdraw funds from more traditional investments, such as annuities, which had been the source of their retirement income and use those funds to buy into the ETS program. The ETS program was marketed not as the sale of a phone to be used by the purchaser but rather as an investment.

The program was described to prospective investors' as offering three (3) management option in which ETS provided a variety of management and maintenance services. Options I and II provided increasing, broad management services for which the investors would pay ETS a monthly fee. Option III, the option to which the investors were directed by the advisor's sales pitch and documents, involved a lease-back agreement which provided that ETS would pay the

investor $984 a year in monthly lease payments in exchange for which "the EQUIPMENT [i.e. pay phone] shall at all times during the Term hereof be under the *sole and absolute control of LESSEE [ETS]*, ..." *Securities & Exchange Commission v. ETS Payphones, Inc., Charles E. Edwards*, in the United States District Court for the Northern District of Georgia, Atlanta Division, Case No. 1:00-CV-2532-JCT.; SEC Exhibit 18, entitled "ETS Payphones, Payphone Equipment Lease Program," pg. 13, paragraph 9 (capitalization in original, italics added).

IV. Certiorari Is Appropriate

As noted by the SEC in its Petition for a Writ of Certiorari and as illustrated above, the Eleventh Circuit's decision in *ETS* is clearly in conflict with concepts and decisions previously ruled upon by this Court. Additionally, the decision conflicts with decisions issued by other federal courts on both the district and circuit levels, as well as conflicting with numerous state court decisions.

The Eleventh Circuit's decision to exclude a contract with a fixed return from the definition of an "investment contract" severely narrows the definition of "investment contract" and creates an environment in which unscrupulous investment promoters can flourish. With very little effort promoters can, and will, structure investment products so as to include a contractual promise of a return and, by doing so, remove themselves from the regulatory jurisdiction of the SEC and, in many cases, its state regulatory counterparts. Clearly, that result is contrary to the legislative policy behind the Acts which were enacted to *protect* the investing public.

The bottom-line effect of the Eleventh Circuit's decision in *ETS* is that investment products which offer contractually guaranteed income to investors along with the promise of the return of the investors' original principal investment do not meet the definition of "investment contract." Obviously, such an outcome flies in the face of logic when viewed in light of Congress's express decision to provide protection under the Acts to individuals who invest in bonds, notes, or even preferred stock - all of which provide for a fixed return in addition to the return of the investors' original investment principal. It is unreasonable to take the position that individuals purchasing investments such as ETS Payphones, Inc. should not be provided the same level of protection afforded their counterparts who invest in bonds, notes, or preferred stock simply because the Eleventh Circuit refused to apply the "investment contract" label to the ETS investment scheme.[4]

The Eleventh Circuit seems to view the existence of the lease-back agreement as a contract which leaves sufficient control in the hands of the investor to exempt the entire investment program from the protections afforded through the Acts. This Court has repeatedly acknowledged that similar investment programs *do* qualify as securities through the application of the *Howey* investment contract concept. Indeed, virtually all investment contracts involve a contract executed by

---

[4] The states recognize that bonds and notes are, generally speaking, identified through the use of the "family resemblance" test rather than the *Howey* test; however, this discussion is intended to draw attention to the similarities in the risks assumed by each category of investors.

the parties, thus the name "investment *contract*." The only arguably distinguishing aspect of the ETS investment program is that the contract provides for a fixed monthly return and fixed sale price. This Court has held that the fact that an investment is non-speculative does *not* exclude it from the definition of an investment contract.

This Court stated in *Howey*, as pointed out above, that "it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value." *Howey* 328 U.S. at 301, 66 S.Ct. at 1104.

As the SEC points out in its Petition for a Writ of Certiorari:

> The "investment contract" category has served as a critical means of bringing a host of unconventional financial arrangements - offering both fixed and variable returns - within the purview of the federal securities laws. Excluding such unconventional investments from the scope of the securities laws because they offer a fixed return or are "contractually guaranteed" would be a radical departure from the enforcement history under the Act and would significantly impair the Commission's ability to protect investors from securities fraud.

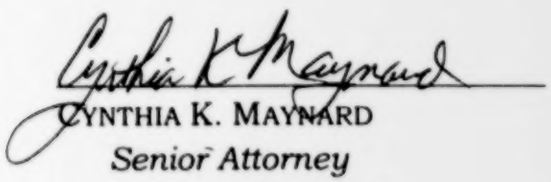
Petition for a Writ of Certiorari, p. 26. As previously noted, the states' securities laws have become entwined with the federal case law. Consequently, just as the Eleventh Circuit's decision, if permitted to stand, would hinder the SEC's effectiveness to protect investors on a national level, the decision will hinder the states' efforts

to protect on the state level.

CONCLUSION

The SEC's petition for a writ of certiorari should be granted.

Respectfully submitted.



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No. 02-1196

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 2002

THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Appellant,

AGAINST

ETS PAYPHONES, INC.
AND
CHARLES E. EDWARDS,

Appellees.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

---

BRIEF FOR PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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March 14, 2003

27 pp

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March 14, 2003

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE IN SUPPORT OF THE SEC'S PETITION FOR WRIT OF CERTIORARI AND BRIEF AMICUS CURIAE IN SUPPORT THEREOF

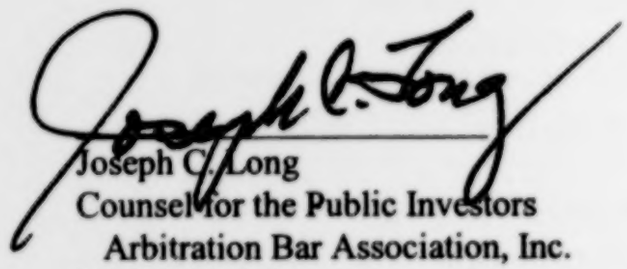
The Public Investors Arbitration Bar Association, Inc. ("PIABA") is a national non-profit voluntary public bar association with a membership of some 550 attorneys. In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters. PIABA hereby respectfully moves for leave to file the attached brief, as **Amicus Curiae**, in the present case. Permission of the appellant, the United States Solicitor General, has been obtained. Permission of Charles E. Edwards, appellee, was sought and denied.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar interests in payphones offered by other companies. The decision of this Court could strongly influence the outcome of these future arbitrations.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. These investments include automated teller machines, credit card processing units, and Internet access terminals, among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied in the information and protection which the state and federal securities acts were designed to provide.

The focus of the brief of the Solicitor General on behalf of the Securities and Exchange Commission accompanying the petition for certiorari is limited to the Eleventh Circuit's analysis of the ETS payphone operation and its implications decision on the federal securities acts. The brief, which PIABA as **Amicus Curiae** seeks permission to file, will, however, have a wider focus. It will address the impact of this Court's decision on arbitration, state securities laws, and other types of similar schemes. It will provide the Court with an understanding of the potential impact that the Court's decision will have in these broader areas.

Respectfully submitted,



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March 14, 2003

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In the
Supreme Court of the United States
October Term, 2002

The United States Securities and Exchange Commission,

Appellant,

against

ETS Payphones, Inc.
and
Charles E. Edwards,

Appellees.

On Petition for Writ of Certiorari to
the United States Court of Appeals
for the Eleventh Circuit
Brief for the Public Investors Arbitration
Bar Association, Inc., as Amicus Curiae

INTEREST OF THE AMICUS CURIAE

The Public Investors Arbitration Bar Association, Inc. ("PIABA") is a national non-profit voluntary public bar association with a membership of some 550 attorneys.[1] In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters.

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[1]Joseph C. Long, a member of PIABA and the undersigned counsel for PIABA, wrote the entire brief. No one other than PIABA, the amicus curiae, has made a monetary contribution to the preparation or submission of this brief.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar interests in payphones offered by other companies. The decision of this Court could strongly influence the outcome of these future arbitrations.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. These investments include automated teller machines, credit card processing units, and Internet access terminals, among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied the information and protection which the state and federal securities acts were designed to provide.

SUMMARY OF ARGUMENT

The Writ of Certiorari should be granted for four reasons. First, the question of national public interest in that it effects the definition of profits under the investment contract test in the federal and state securities acts. Second, the present decisions of this Court on this issue are ambiguous and need to be clarified. Third, the decisions of the various Courts of Appeals on the issue of "profits" are badly divided. Finally, the decision of the Eleventh Circuit is in conflict with the position of the SEC, the state courts under similar definitions in the state securities acts, and the state securities agencies themselves.

ARGUMENT

POINT I

THE ISSUE IN THIS CASE INVOLVES GREAT NATIONAL PUBLIC INTEREST AND, THEREFORE, SHOULD BE REVIEWED BY THIS COURT

PIABA believes the SEC has greatly understated the issue in the present case. The real issue is whether any debt security or contract requiring the payment of a fixed return can be an investment contract under the statutory definition of a "security" in either the Securities Act of 1933[2] or the Exchange Act of 1934.[3] The Eleventh Circuit, in the present case, interpreted this Court's decision in *United Housing Foundation v. Forman*, 421 U.S. 837 (1975), defining the "profit" element of *Howey*[4] test for investment contracts to exclude either the payment of interest or contract fixed return obligations. It reached this conclusion based upon its reading of *United Housing* to require that the investor's profit must come from the earnings of the enterprise. Interest or fixed return contract obligations may or may not come from these earnings because these obligations must be paid without regard to whether the enterprise earns a profit.

The correctness of this interpretation is a matter of national public interest. Both the SEC and the state securities agencies spend a great deal of their enforcement resources dealing with novel or irregular securities. By far the most litigated portion of the statutory definition of a security is "investment contracts." Virtually all of these novel securities cases also involve either Ponzie schemes or fraudulent conduct, often aimed

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[2] 15 U.S.C. §77(b)(1).

[3] 15 U.S.C. §78(c)(a)(10).

[4] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

at the unsophisticated and the elderly. The losses to the general public are enormous.

To understand the size of the problem, it should be noted that, in addition to the SEC, at least 18 state securities agencies have taken action against ETS.[5] When enforcement activities against other payphone operations are added, the number of state enforcement actions rises to over 200.[6] The State of California alone has issued 143 Desist and Refrain Orders against 54 such entities.[7]

These payphone cases are, however, merely the tip of the iceberg. In the past, the agencies have had to deal with similar schemes involving automatic teller machines and other sale and lease-back promotions ranging from rail cars to trailer trucks. *See e.g.*, *United States v. Jones*, 712 F.2d 1316 (9th Cir.), cert. denied, 464 U.S. 986 (1983)(trailer trucks).

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[5]*ETS Payphones, Inc.*, 2002 WL 1586379 (Ind. Div. Sec. June 7, 2002); *National Communications Marketing, Inc.*, 1998 WL 704697 (Kan. Sec. Com. Sept. 25, 1998); *Jerry Klemp*, 1999 WL 20390 (Wis. Com. Sec. Jan. 8, 1999); *Jerome Alex Zanowski*, 2000 WL 1847107 (Ariz. Corp. Com. Nov. 30, 2000); *ETS Payphones, Inc.*, 2001 WL 422179 (Ala. Sec. Com. Feb. 6, 2001); *National Communications Marketing, Inc.*, 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001); *Phillip L. Helton*, 2001 WL 1193030 (Mo. Div. Sec. Oct. 2, 2001); *Linda L. Eberly*, 2002 WL 1151509 (Pa. Sec. Com. May 9, 2002); *Gary Randolph Hayden*, 2002 WL 1575117 (Tex. St. Sec. Bd. July 9, 2002); *Robert L. Scott*, 2002 WL 31089631 (Ohio Dept. Com. Aug. 29, 2002); *Department of Banking and Finance v. Mehl*, 2002 WL 31452438 (Fla. Sec. Div., Final Order, Oct. 17, 2002); and *Stigall v. Sec. of State*, Case No:EN-18626 Final Decision (Sept. 6, 2002). The New York and California decisions are reported on the Internet at www.oag.state.ny.us/press/2002/jun/jun12C_02.html, and www.corp.ca.gov/pressrel/nr0016.htm.

[6]Westlaw search, MSEC-CS, payphones /s securities. The search was done on March 11, 2003.

[7]Cal. Corp. Comm'n, Press Release 00-16 (2000), available at www.corp.ca.gov.

This problem will also continue into the future. Ads are presently running on national television, offering similar contracts on both Internet site locations and credit card processing machines. Many of these schemes are advertising that they are the successor to the payphone opportunities!

Beyond the sale and lease-back cases, the SEC and state agencies have had to deal with wide-spread Ponzi schemes involving promissory notes and prime bank frauds. *See e.g.*, *State v. Gerisch*, 49 P.3d 392 (Idaho 2002) and *Mosley v. State*, 253 Ga. App. 710, 560 S.E.2d 305 (2002)(promissory notes); *SEC v. Marino*, 2000 WL 33678041 (D. Utah Oct. 6, 2000) and *SEC v. Pinckney*, 923 F.Supp.76 (E.D.N.C. 1996)(prime bank cases). The states have also been faced with the fraudulent sale of viatical settlement contracts. *See e.g.*, *Siporin v. Carrington*, 200 Ariz. 97, 23 P.3d 92 (App. 2001). All these investments involve either debt interests or fixed return contracts and would not be investment contracts under the Eleventh Circuit's decision.

If the Eleventh Circuit decision is upheld, the SEC will lose its most effective weapon to control and combat these schemes. Further, while the state courts are not obligated to follow federal decisions, they often do. Thus, a huge gap in both the federal and state agency enforcement programs will result. The white collar criminals will have carte blanche to conduct these various schemes with impunity.[8]

The problem will also hamper criminal prosecutions and civil recovery. If the interests are not investment contracts or securities, criminal enforcement actions such as *Szpunar v. State*, 2003 Ind. App. LEXIS 298 (Ind. App. Feb. 27, 2003) can not be brought. Many victims are now able to bring civil securities actions or arbitrations to recover their losses. For example, there

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[8]It is true that many of these schemes are not presently structured to provide a fixed return or the payment of interest. However, such programs can easily be altered to include these features, especially where there is no intent by the promoter to meet these payment obligations.

are presently a number of NASD arbitrations where the defrauded investors have sought to recover their money lost in payphone investments. *See e.g., In re Arbitration: Daugherty and Sowers*, 2002 WL 1944487 (NASD 2002) and *In re Arbitration: Womble and Locust Street Sec., Inc.*, 2001 WL 1636341 (NASD 2001)(both ETS cases). If the Eleventh Circuit position is upheld, using the investment contract theory under the federal securities acts will be foreclosed to them.

Because of the impact of the Eleventh Circuit's decision on both state and federal enforcement activities as well as its impact upon investor recovery, this Court should grant certiorari to review the Eleventh Circuit's decision.

POINT II

THE CONTROLLING AUTHORITIES FROM THIS COURT ARE AMBIGUOUS AND SHOULD BE CLARIFIED

A major reason that the Court should grant certiorari in the present case is that the controlling decisions of this Court appear to be ambiguous. The first case to deal with the concept of an investment contract was *SEC v. C.M. Joiner*, 320 U.S. 344 (1943). The Court in *Joiner* recognized that the definitions of a security found in both the Securities Act of 1933 and the Exchange Act of 1934 are not true definitions.[9] Instead, they are definitions by enumeration. Some of the instruments named in the definition are "pretty much standardized and the meaning alone carries well settled meaning." 320 U.S. at 351. "Others are of a more variable character and were necessarily designated by more descriptive terms, such as ... 'investment contract'...." *Id.* *Joiner* recognized that:

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[9]Nor do the state securities acts which preceded them have true definitions. See the Author's Treatise, 12 and 12A, Joseph C. Long, Blue Sky Law §1:15 (2002)(Hereinafter "Blue Sky Law § ___") for a discussion of the development of the statutory definition.

> [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing [that] established [them] as 'investment contracts.' Id.

The Court then suggested that whether a device comes within or is excluded from one category of the definition does not prevent it from being included in another portion of the definition. *Id.* at 352.

The Court finally concluded:

> The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offering be judged as being what they were represented to be.[10]

Id. at 352-353. Nothing in the Court's decision hints that fixed return or debt securities should be excluded from classification as "investment contracts."

Three years later, in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), again considered what constituted an investment contract.

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[10]This statement is particularly important in the present case because it emphasizes what the investors thought they were getting. In the present case, the contracts were technically cast in the form of fixed payments for rent of the phone. Many of the investors in the present case were elderly. From their prospective, they were making an investment, would receive a return on that investment, and would not participate in the management of the investment. From their prospective, they were buying an investment contract, not a contract for the payment of rent on a payphone.

Initially, the Court made two important observations. First, it noted that the term "investment contracts" was not a defined term either in the statute itself or the legislative history. However, it pointed out the term had been in use for a number of years under the state securities or Blue Sky laws. The Court also pointed out "it had been broadly construed by state courts so as to afford the investing public, a full measure of protection." Then, the Court went on to note that "investment contracts":

> [E]mbodies a flexible rather than static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. Id. at 299.

The Court, then, announced the now famous test for an investment contract:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. Id. at 298-299.[11]

Finally, the Court concluded the scheme in *Howey* was an investment contract. In doing so, the Court stated the essence of both investment contracts and securities in general:

> Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits;

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[11]The Court restated this test slightly differently:

> The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. Id at 301.

> the promoters manage, control and operate the enterprise. Id. at 299.

A security will be present when the capital providing function is separated from the management function. The investor supplies at least part of the capital, the promoter or a third party supplies the management, control, and operation. The remaining two elements of *Howey* further refine the idea. The common enterprise element requires that the enterprise be active rather than passive (such as holding but not developing raw land). The **expectation** of profits element requires that the investment be motivated by his expectation that he will receive a return on his investment.

Again, nothing in the language used or the discussion in the *Howey* case suggests that the profit can not be in the form of fixed payments or interest paid on debt securities. In fact, as the SEC notes in its brief in support of the petition, SEC Brief, p.12, two of the state cases relied upon by the Court in *Howey* involved fixed income or a "guaranteed" return. *See People v. White*, 12 P.2d 1078 (Cal. App. 1932) and *Stevens v. Liberty Packing Corp.*, 161 A. 193, 195 (N.J. Ch. 1932).[12]

In 1975, in *United Housing Foundation, Inc. v. Forman*, 423 U.S. 837 (1975), the Court muddied the waters. The thrust of *United Housing* was to distinguish those cases where receiving a true "profit" was the motivating force behind the investor's investment from those cases where the purchaser of the property was motivated by "the desire to use or consume the item purchased...." 423 U.S. at 852. The Court recognized the *Howey* test and then made the statement which led the Eleventh Circuit astray:

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[12]*See* Blue Sky Law §1:17. For a discussion of the lower federal cases cited in *Howey*, *see* id. §1:18.

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment as in *Joiner*, *supra*, ... or a participation in the earnings resulting from the use of investor's funds, as in *Tcherepnin v. Knight....Id.*

This statement does not support the exclusion of all fixed rate investments or debt securities from coverage by "investment contracts" for two reasons.[13] First, it is clear from the language used that the Court was referring to its past decisions. As it happens, the Court, at that time, had never considered an investment contract case involving either a fixed return or a debt security. Recognizing that the Court had never had the note problem before it, the Fifth Circuit in *Meason v. Bank of Miami*, 652 F.2d 542, 550, N.17 (5th Cir. 1981) stated that the quoted language "seems to us to be dubious value in [the note] context."

Second, the words "the earnings resulting from the use of investor's funds" turns the *Howey* test on its head. The focus of *Howey* was on the **expectation** of a profit **to the investor**, not necessarily to the enterprise in which the investment was made.[14] In the case of fixed rate or debt securities, the investor makes a profit, even if the enterprise in which he invests does not.

The Court further muddied the waters in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).[15] *Reves* established the test for when promissory notes are securities. However, in footnote 4, the Court made the concept of "profits" more ambiguous by saying:

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[13]*See* Blue Sky Law §2:58.

[14]*See*, for example, *Bell v. Health-Mor, Inc.*, 549 F.2d 342 (5th Cir. 1977) where the investor was to receive a $10 rebate on the cost of his vacuum for every referral made whether the referral bought or not.

[15]*See* Blue Sky Law §2:58, N.11.

> We emphasize that by "profits" in the context of notes, we mean "a valuable return on an investment," which undoubtedly includes interest. We have, of course defined "profit" more restrictively in applying the *Howey* test to what are claimed to be investment contracts. [Citing *Forman*]. . . . Because the *Howey* test is irrelevant to the issue before us..., we decline to extend its definition of "profits" beyond the realm in which that definition applies. 494 U.S. at 953, N.4.

In summary, the Court should grant certiorari in the present case to clear up the ambiguity as to its intent as to the profits element of the *Howey* test. This ambiguity needs to be resolved.

POINT III

THE DECISIONS OF THE COURTS OF APPEALS ON THE ISSUE OF "PROFITS" UNDER THE HOWEY TEST ARE IN CONFLICT

With the decisions of this Court ambiguous over the proper interpretation of "profits" under the *Howey* test, it is not surprising that the decisions of the various Court of Appeals are in conflict. Further, the Eleventh Circuit decision in the present case is also in conflict with other decisions by the Fifth Circuit prior to the creation of the Eleventh Circuit.[16] *See Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981)(rejecting the district court's holding that an investment was not an investment because the investor was paid a fixed return);[17] *Cameron v. Outdoor*

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[16]In *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir. 1981)(en banc), the Eleventh Circuit adopted as precedent all decisions of the former Fifth Circuit decided prior to October 1, 1981.

[17]*Meason* indicates other courts have not been restricted by a concept of a fixed return disqualifying the finding of an investment contract., citing

Resorts of America, Inc., 61 F.2d 187 (5th Cir. 1979); *Bell v. Health-Mor, Inc.*, 549 F.2d 342 (5th Cir. 1977).

The Sixth, Seventh, Eighth, and Tenth Circuits also appear to have accepted the Eleventh Circuit's position. *See Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir.), cert. denied, 454 U.S. 1124 (1981); *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), cert. denied, 451 U.S. 911 (1981); *First Fin. Fed. Sav. & Loan v. E.F. Hutton, Mortgage Co.*, 834 F.2d 685, 689 (8th Cir. 1987); and *Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993).

The Seventh Circuit, however, appears to be willing to reconsider its position in *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984). Of the above quoted language from *United Housing*, the court said "at the time of the *Forman* decision, the Court had not yet considered a debt instrument." 745 F.2d at 491. The court then went on to say:

> As a matter of original principles, however, one may question the wisdom of excluding fixed interest payments from the definition of 'profits.' Congress listed a large number of terms, including the seemingly broad term 'investment contract,' in the definitional sections of the securities acts apparently in order to prevent imaginative promoters from avoiding regulation by inventing nonconventional instruments. [Citation omitted]. It is arguable that giving a restrictive definition to the term 'profits' would be in frustration of Congress's intention. It is of course true that the Supreme Court has strongly indicated that the

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Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); *SEC v. Nat'l Executive Planners, Ltd.*, 503 F.Supp. 1066 (M.D.N.C. 1980); and *SEC v. Weeks Sec. Inc.*, 483 F.Supp. 1239, 1243-1244 (S.D. Tenn. 1980).

> term 'profits' should exclude fixed interest payments, and decisions of this court contain language following the path set by the Court. *Id.*

However, both the Third and the Ninth Circuits have rejected the Eleventh Circuit's position. They hold that fixed return or debt securities can be investment contracts. The Third Circuit in *SEC v. Infinity Group Co.*, 212 F.3d 180, 189 (3d Cir. 2000), stated "the definition of security does not turn on whether the investor receives a variable or fixed rate of return." Similarly, in *United States v. Carman*, 577 F.2d 556, 563 (9th Cir. 1978), the court rejected the defendant's argument that the student loans involved in that case were not investment contracts because the return was in the form of fixed interest and guaranteed by the federal government. See *also United States v. Farris*, 614 F.2d 634, 641 (9th Cir.1979)(promissory notes on real estate) and *United States v. Jones*, 712 F.2d 1316 (9th Cir.), cert. denied, 464 U.S. 986 (1983)(sale and lease back of semi-trailer).

More specifically, two federal district courts, one from the Ninth Circuit, in addition to the trial court in the present case, have found payphone schemes to be investment contracts. *SEC v. Phoenix Telecom, LLC*, 2000 U.S. Dist. LEXIS 22314 (N.D. Ga. Aug. 2, 2000); *SEC v. Alpha Telecom, Inc.*, 187 F. Supp.2d 1250 (D.Ore. 2002); and *SEC v. ETS Payphones, Inc.*, 123 F. Supp.2d 1349 (N.D.Ga. 2000). The *Phoenix Telecom* case had the same type of fixed rental fee agreement as in the present case. As was seen in Point I, the arrangement involved in the *Alpha Telecom* case could have easily been converted to a fixed return agreement.

The Court should grant certiorari to resolve the split between the Courts of Appeals and the inconsistency in the opinions of the Eleventh Circuit.

POINT IV

THE ELEVENTH CIRCUIT'S DECISION IS IN CONFLICT WITH THE INTERPRETATION OF THE SEC, THE STATE COURTS, AND THE STATE SECURITIES AGENCIES ON THE ISSUE OF "PROFITS"

As the SEC notes in its Brief, 23-24, the Eleventh Circuit's decision in the present case runs contrary to the long standing position of the SEC. *See e.g.*, *In re Abbett, Sommer & Co.*, 44 S.E.C. 104, 1969 WL 95369 (1969) and *In re Union Home Loans*, 26 S.E.C. Dkt 1517, 1982 WL 522493 (Dec. 16, 1982).

The Eleventh Circuit's holding also runs contrary to the decisions of many state courts construing the definition of "investment contracts" under the states securities acts to cover both fixed payment agreements and promissory notes. *See e.g.*, *State v. Gerisch*, 49 P.3d 392 (Idaho 2002); *Mosley v. State*, 253 Ga. App. 710, 560 S.E.2d 305 (2002); *Bayhi v. State*, 629 So.2d 782 (Ala. Crim. App. 1993); *State v. Philips*, 108 Wash.2d 627, 741 P.2d 24 (1987); and *People v. Milne*, 690 P.2d 629 (Colo. 1984), all promissory note cases. *See also Manns v. Skolnik*, 666 N.E.2d 1236 (Ind. App. 1996), a contractual obligation to pay fixed return case, *King v. Pope*, 91 S.W.3d 314 (Tenn. 2002), a payphone case with fixed monthly payments similar to ETS, and *Szpunar v. State*, 2003 Ind. App. LEXIS 298 (Ind. App. Feb. 27, 2003), another payphone case.

Several of these state decisions speak directly to the question of whether fixed fees or interest can qualify as "profits." In *Payable Accounting Corp. v. McKinley*, 667 P.2d 15, 19 (Utah 1983), the court said "the critical factor is not whether the rate of return is fixed, but whether the 'investment transaction' is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise."

In *People v. Figueroa*, 41 Cal. 3d 714, 715 P.2d 680, 224 Cal. Rptr. 7119 (1986)(en banc) also addressed the issue of fixed payments, saying:

> Many "investment contracts"...contemplate both a variable and a fixed return. The investment contracts in [*People v. Coster*, 151 Cal. App.3d 1188, 199 Cal. Rptr. 253 (App. 1983)], for example purported to give the investor a 20 percent "fixed" return on principal and 1 percent of the **gross** company income. [Citation omitted.] Both kinds of return, as well as a recoupment of principal depended on the success of the business.... It would be illogical to [to exclude] a promissory note transaction simply because the promised return ... is to take the form of interest at a "fixed" rate. Id. at 740, 715 P.2d at 698, 224 Cal. Rptr. at 737. [Emphasis added.]

Likewise, the state securities agencies themselves have rejected the Eleventh Circuit's approach. As noted in Point 1, at least 18 state securities agencies have brought administrative enforcement actions against ETS. New York has also brought an action against another company offering a similar fixed return plan. *State of New York v. Justin*, 237 F. Supp.2d 368 (W.D.N.Y. 2002). At least two of these state ETS cases were contested cases, and both were decided **after** the Eleventh Circuit's opinion in the present case. **Both** rejected the Eleventh Circuit's position. In *Stigall v. Sec. of State*, Case No:EN-18727 Final Decision (Sept. 6, 2002), slip op. at 13, the Georgia Commissioner said:

> The Commissioner rejects the Eleventh Circuit's analysis of the third element of *Howey* as being inextricably intertwined with its narrow view of "profits." ... [T]he fact that there is a contractual guarantee of payment which might be satisfied from the capital of the enterprise is as irrelevant in this case as it would be in a case involving a

> promissory note. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."

Likewise, in *Department of Banking and Finance v. Mehl*, 2002 WL 31452438 (Fla. Sec. Div., Final Order, Oct. 17, 2002), the Florida Comptroller rejected the Eleventh Circuit approach as representing the law of Florida. He said, "Florida law does not use such a narrow construction of 'profits,' it has not distinguished between fixed or variable returns to the investor."

In summary, since the Eleventh Circuit's position runs contrary to the positions held by the SEC, the state courts, and the state securities agencies, this Court should grant certiorari to examine the issue.

CONCLUSION

For the above outlined reasons, PIABA urges the Court to grant the SEC's petition for Writ of Certiorari.

Dated: March 14, 2003
Norman, OK 73072

Respectfully submitted,

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EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

No. 02-1196

In The Supreme Court of the United States

Securities and Exchange Commission, Petitioner

v.

Charles E. Edwards, Respondent

AMICI CURIAE LODGING

IN SUPPORT OF THE

AMICI CURIAE BRIEF PETITION

No. 02-1196

(17)

In The Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

***AMICI CURIAE* LODGING IN SUPPORT OF THE *AMICI CURIAE* BRIEF PETITION**

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***Second Amended Complaint For Declaratory Judgment, In Re PSA, Inc., a Delaware corporation, and Affiliates, Debtors; PSA, Inc, and ETS Payphones, Inc. v. Stow,* in the United States Bankruptcy Court for the District of Delaware, case no. 00-3570 (EIK), Adversary Proceeding No. A-01-4711**

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE PSA, INC., a Delaware corporation, and AFFILIATES, DEBTORS.	Chapter 11 Case No. 00-3570 (EIK) Jointly Administered Case Nos. 00-3570 (EIK) through 00-3572 (EIK) and 00-3718 (EIK) through 00-3725 (EIK)
PSA, INC, and ETS PAYPHONES, INC. PLAINTIFFS, vs. FREDERICK STOW, and KLARA H. SCOTT, on behalf of themselves and others similarly situated CLASS.	Adversary Proceeding No. A-01-4711

SECOND AMENDED COMPLAINT FOR DECLARATORY JUDGMENT

Plaintiffs PSA, Inc., ETS Payphones, Inc. ("ETS") and related entities, debtors and debtors in possession in the above-styled chapter 11 cases (collectively, "Debtors"), file this Second Amended Complaint for Declaratory Judgment against the named Defendants individually and as representatives of the similarly situated class they represent (collectively, the "Class"). This Second Amended Complaint for Declaratory Judgment replaces all prior Complaints for Declaratory Judgment.

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BY: Nicholas Bankhead 3/7/03
Deputy Clerk

INTRODUCTION

1. Debtors bring this action in order to clarify the nature of the interests held by the Class in connection with "sale-leaseback" arrangements entered into by Debtors and the members of the Class relating to coin-operated telephones.

2. Debtors seek a declaration regarding the legal character of the interests held by the Class members. Such a declaration is important because, among other reasons: (i) the possibility of inconsistent or varying adjudications with respect to the individual members of the Class could establish incompatible standards of conduct for Debtors and render a successful reorganization impracticable; and (ii) as a practical matter, a class-wide determination that the arrangements are not "true leases" would remove an otherwise insurmountable obstacle to a successful reorganization of the Debtors' estates, while a holding to the contrary could necessitate the conversion of the Debtors' proceedings into one arising under chapter 7 of the Bankruptcy Code. In short, Debtors anticipate that if the court finds that the sale-leaseback arrangements are not "true leases," a successful reorganization may be possible, and the Class may receive a future stream of income in the form of dividends; if the court finds that the Class holds "true leases," or in the absence of a binding determination that they do not hold "true leases," Debtors anticipate that Debtors may be forced into liquidation, and the Class will receive minimal, if any, recovery.

PARTIES

3. ETS is a closely held Georgia corporation and the parent corporation of PSA, Inc. and the nine other Debtors in these jointly administered bankruptcy cases. ETS was founded in 1994 by Charles E. Edwards ("Mr. Edwards"). The Debtors operate and manage coin

operated telephones, private automated teller machines, and air and vacuum machines at various locations throughout the United States, Puerto Rico, and the Virgin Islands.

4. Mr. Frederick Stow ("Stow") is an individual residing at 195 Lakeview Circle, Montgomery, Texas 77356. Mr. Stow paid $101,250 to Debtors in a series of "sale-leaseback" arrangements in connection with coin operated telephones on January 15, 1999. Mrs. Klara H. Scott ("Scott") is an individual residing at 9596 Escondido Drive, Willis, Texas 77318. Mrs. Scott paid $130,750 to Debtors in a series of "sale-leaseback" arrangements in connection with coin operated telephones from January, 1998 through February 15, 2000. Each such person is referred to herein as a "named defendant" or "Representative."

JURISDICTION AND VENUE

5. On September 11, 2000 and September 21, 2000 (collectively, the "Petition Date"), the Debtors filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§101-1330 (as amended and supplemented, the "Bankruptcy Code"). The Debtors' cases are being jointly administered for procedural purposes pursuant to Rule 1015(b) of the Federal Rules of Bankruptcy Procedure. A Committee of Unsecured Creditors, including persons who entered into sale-leaseback agreements with Debtors who are members of the putative Class, was appointed pursuant to section 1102 of the Bankruptcy Code on September 27, 2000, and has retained its own counsel (the "Creditors Committee"). An examiner was appointed by the Court on December 21, 2000.

6. Pursuant to sections 1107 and 1108 of the Bankruptcy Code, Debtors continue to operate their businesses as debtors in possession.

7. This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper in this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

SUMMARY OF THE CASE

8. This adversary proceeding seeks determination of a primary issue affecting the course of these chapter 11 cases: the proper characterization of the Agreements (as defined below) and the Class' respective rights against the estates. Resolution of this issue may solve what could otherwise be an insurmountable obstacle to a successful reorganization. Debtors seek a declaration that the "sale-leaseback" arrangements under the Agreements are not "true leases" and that the payphones underlying the Agreements are therefore assets of the estate. Such a holding would give the Class members the status of unsecured creditors of the estates.

9. The Class members paid, directly or indirectly, for public payphones by entering into form sale-leaseback agreements with Debtors (the "Agreements"). A true and complete copy of a representative Agreement is attached hereto as Exhibit A. Pursuant to the Agreements, Debtors maintained possession of the phones and managed and operated the phones on behalf of the members of the Class. The Class members retained little, if any, control over the payphones. The Class members did not participate in the operation of the payphones. Debtors paid the Class a stream of income in monthly installments.

10. There was confusion regarding the true legal character of the Agreements at the time the Debtors and Class members entered into the Agreements. The Class members and Debtors generally understood that the Agreements were "leases." Class Members and Debtors were mistaken, however, if they believed the Agreements to be "true leases."

THE AGREEMENTS ARE NOT TRUE LEASES

11. The Agreements are not true leases and the right to receive the stream of payments should be characterized as a prepetition unsecured obligation.

12. If the right to receive this stream of payments is determined to be a prepetition unsecured obligation of Debtors, then Debtors will be in a better position to formulate a confirmable plan of reorganization. It is believed that such a reorganization plan would give the Class a much greater opportunity to recoup as much as possible of their initial payments because they would become shareholders in the reorganized company. However, if the stream of payments is classified as a true lease, the Debtors' failure to make the monthly payments postpetition will result in accrued and unpaid administrative claims in excess of $50,000,000. Under section 507 of the Bankruptcy Code, all administrative expenses are given priority and must be paid ahead of all claims of unsecured creditors. Thus, if the Agreements are classified as "true leases," then Debtors will be liable for approximately $50,000,000 in administrative claims, which must be paid before any money is available to the unsecured creditors. Debtors' estates cannot cover these administrative expenses and the Debtors will be forced to convert these cases to cases arising under chapter 7 of the Bankruptcy Code. The Debtors believe that such a result would mean the death knell of the companies.

13. The classification of the Agreements is critical to the success or failure of Debtors' attempts to formulate a confirmable plan of reorganization under the Bankruptcy Code. A substantial part of the Debtors' plan of reorganization includes the sale of a portion of the Debtors' assets in order to raise sufficient funds to emerge from Chapter 11. Debtors have determined that certain regions in which they operate are not profitable, and significant value

could be obtained by selling the phone routes in those areas. Additionally, throughout the course of these Chapter 11 cases, the Debtors have systematically identified and disconnected unprofitable phones throughout the country. The Debtors desire to sell this excess inventory in order to maximize value to the Class.

14. If this Court determines that the Agreements are not true leases, the Class will hold prepetition unsecured claims under the Bankruptcy Code entitling the Class to, among other distributions, shares of stock in the reorganized companies pursuant to the proposed plan of reorganization. This will give the Debtors an opportunity to survive these bankruptcy proceedings and formulate a plan of reorganization which may include the sale of a large part of the assets. It is believed that a plan of reorganization under these terms provides the best opportunity for recouping as much as possible by the Class.

THE SEC ACTION

15. A recent decision of the United States District Court for the Northern District of Georgia confirms that the Agreements are not true leases.

16. The United States Securities and Exchange Commission ("SEC") brought suit against ETS and Mr. Edwards individually for, among other allegations, the unregistered offering of securities in violation of the registration provisions of federal securities laws. The SEC's action concerned, among other things, the marketing of the Agreements at issue herein. Without admitting or denying the SEC's allegations, ETS consented to a preliminary injunction prohibiting future violations of the federal securities laws. Among the practical effects of the injunction was to prohibit the further sale of the coin operated payphones as unregistered securities.

17. Mr. Edwards, who is not a party to this action, did not consent to the preliminary injunction. Accordingly, the SEC sought an order imposing such an injunction. Following a hearing, on November 17, 2000, Judge Jack T. Camp of the United States District Court for the Northern District of Georgia, Atlanta Division, held that the SEC had established a prima facie case that Mr. Edwards was selling securities as defined in the federal securities laws and granted the SEC's motion for a preliminary injunction against Mr. Edwards.[1]

18. The United States District Court for the Northern District of Georgia has held that the SEC established a prima facie case that the Agreements are investment contracts.

19. Mr. Edwards has agreed to cooperate with the SEC and the Official Committee of Creditors with regard to the repayment of certain assets, and such negotiations are ongoing at this time. The Creditors Committee has been provided extensive financial records from Mr. Edwards, including an accounting produced in the SEC proceeding.

CLASS REPRESENTATION ALLEGATIONS

20. Debtors bring this action as a defendant class action under Rules 23(a) and 23 (b)(1) and (b)(2) of the Federal Rules of Civil Procedure as incorporated in Rule 7023 of the Federal Rules of Bankruptcy Procedure. The Class is defined as all persons or entities who entered into the Agreements with any of Debtors and thereby paid money in connection with the payphone equipment lease program for coin operated telephones between June 7, 1994 and September 10, 2000.

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[1] Mr. Edwards has appealed Judge Camp's Order to the Eleventh Circuit Court of Appeals.

21. The Class consists of approximately 15,000 geographically dispersed persons and entities. The Class is therefore so numerous that joinder of all members is impracticable.

22. It is anticipated that the named defendants' defenses will be typical of the defenses of the Class.

23. The named defendants will fairly and adequately protect the interests of the members of the Class. Each of the named defendants has authorized the bringing of this class action suit and agreed to serve as a Class Representative. To the knowledge of Debtors, the Representatives have no conflict of interest with the other Class members. The Representatives' interests are in line and not antagonistic with those of the Class, as all such parties have entered into similar Agreements. The Representatives are a fair cross section of the Class as they have participated during the life of the "sale-leaseback" program and have paid varying amounts to Debtors.

24. The named defendants will have the opportunity to retain counsel competent and experienced in bankruptcy litigation. Defendants' counsel may seek compensation for their services as providing benefit to the estates under section 503(b) of the Bankruptcy Code.

25. A defendant class action is superior to other available methods of the fair and efficient adjudication of this controversy. Furthermore, it would be inefficient to attempt to adjudicate each Class member's dispute with the estates individually. No difficulty is anticipated in the management of this action as a class action.

26. The prosecution of separate actions against individual Class members would create a risk of: (a) inconsistent or varying adjudications with respect to individual members of the Class which would establish incompatible standards of conduct for Debtors; and

(b) adjudications with respect to individual members of the Class which would as a practical matter be dispositive of the interests of the other members not party to the adjudications, or substantially impair or impede their ability to protect their interests.

27. Debtors have acted, or refused to act, on grounds generally applicable to the Class, thereby making appropriate declaratory relief with respect to the Class as a whole.

28. As set forth below, common questions of law and fact exist as to all members of the Class.

29. The defenses, arguments, and rights of the Representatives are typical of the defenses, arguments, and rights of all members of the Class, who entered into Agreements for coin operated pay phones with Debtors. The outcome and relief the Debtors seek is common to the Class.

30. This class action is superior to other available methods for the fair and efficient adjudication of the controversy. This forum is desirable for concentrating the litigation of the claims, since this Court will be ultimately deciding the treatment of the members and other creditors' claims in conjunction with the confirmation of a plan of reorganization.

COUNT I

DECLARATORY JUDGMENT

31. Debtors reallege and incorporate by reference the allegations set forth in paragraphs 1 through 30 of this Petition for Declaratory Judgment.

32. An actual controversy exists concerning whether the Class' telephone "sale-leaseback" agreements with Debtors are true leases. The controversy is governed by the Bankruptcy Code.

33. The Class members paid, directly or indirectly, for public payphones by entering into form sale-leaseback agreements with Debtors. Pursuant to the Agreements, Debtors maintained possession of the phones and managed and operated the phones on behalf of the members of the Class. The Class members retained little, if any, control over the payphones. The Class members did not participate in the operation of the payphones. Debtors paid the Class a stream of income in monthly installments.

34. The Class Members and Debtors need the Court to clear up confusion regarding the legal character and legal effect of the Agreements.

35. The arrangement between Debtors and the Class is not a "true lease." As such, the purported right of the Class to receive a stream of income under the Agreements is a prepetition unsecured claim under the Bankruptcy Code.

WHEREFORE, Debtors respectfully request that this Court enter judgment as follows:

1. Certifying the Class as defined herein.

2. Declaring that the named defendants are appropriate and adequate Class representatives and designating them as such.

3. Declaring that all members of the Class are bound by the judgment herein.

4. Declaring that the Agreements are not true sales contracts and leases.

5. Granting such other relief as deemed appropriate by the Court.

Respectfully submitted this 18th day of October, 2001.

W. Scott Sorrels
John M. Gross
Shannon Lowry Nagle
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-AND-

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Counsel for Debtors and Debtors-in-possession

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE PSA, INC., a Delaware corporation, and AFFILIATES, DEBTORS.	Chapter 11 Case No. 00-3570 (EIK) Jointly Administered Case Nos. 00-3570 (EIK) through 00-3572 (EIK) and 00-3718 (EIK) through 00-3725 (EIK)
PSA, INC, and ETS PAYPHONES, INC. PLAINTIFFS, vs. FREDERICK STOW, and KLARA H. SCOTT, on behalf of themselves and others similarly situated CLASS.	Adversary Proceeding No. A-01-4711

AFFIDAVIT OF SERVICE

STATE OF DELAWARE)
) SS
NEW CASTLE COUNTY)

Chandra Rudloff, being duly sworn according to law, deposes and says that she is employed by the law firm of Young Conaway Stargatt & Taylor, LLP, attorneys for PSA, Inc., in the within captioned matter, and that on the 18th day of October, 2001, she caused the following document to be served, as indicated, upon the parties identified on the attached service list:

SECOND AMENDED COMPLAINT FOR DECLARATORY JUDGMENT

Chandra Rudloff

SWORN TO AND SUBSCRIBED before me this 18th day of October 2001.

Notary Public
My Commission Expires:

SANDRA L. VANDYKE
NOTARY PUBLIC
STATE OF DELAWARE

SERVICE LIST
PSA, Inc.
10/18/2001

Kevin Gross, Esq.
Rosenthal, Monhait, Gross & Goddess, P.A.
919 Market St./Ste. 1401 Mellon Bank Ctr
P.O. Box 1070
Wilmington, DE 19899-1070
Hand Delivery

Mr. Frederick Stow
195 Lakeview Circle
Montgomery, TX 77356
First Class Mail

Mrs. Klara H. Scott
9596 Escondido Drive
Willis, TX 77318
First Class Mail

Findings of Fact, Conclusions of Law and Order Confirming The Joint Reorganization Plan Of PSA, Inc., ETS Payphones, Inc. and ETS Vending, Inc., Et Al.,

in the case of
In Re: PSA, Inc., ETS Payphones, Inc., ETS Vending, Inc. Et Al.,
in the United States Bankruptcy Court
for the District of Delaware,
Case No. 00-3570

Please Note:

This entire document is 550 pages, 245 of which consist of a table entitled "All USA Assumption List 111301."

In the interest of conserving papers, and recognizing that the contents of the list are not relevant to the purpose for which the document has been provided to the Court, only the first and last pages of the table have been included as a sampling of the table's contents.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE:	)	
	)	CASE NO. 00-3570 (EIK)
PSA, INC.,	)	
ETS PAYPHONES, INC.,	)	CHAPTER 11
ETS VENDING, INC., ET AL.	)	(JOINTLY ADMINISTERED
	)	Case Nos. 00-3570 through
	)	00-3572 and 00-3718 through
Debtors.	)	00-3725)

CERTIFIED: AS A TRUE COPY: ATTEST:
DAVID D. BIRD, CLERK 3/7/03
U.S. BANKRUPTCY COURT
BY: Michele Barksdale
Deputy Clerk

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER CONFIRMING THE JOINT REORGANIZATION PLAN OF PSA, INC, ETS PAYPHONES, INC. AND ETS VENDING, INC., ET AL.

Debtors having filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101-1330 (as amended and supplemented, the "Bankruptcy Code"), on September 11 and 21, 2001; and Debtors and the Official Committee of Unsecured Creditors (the "Creditors' Committee"),[1] having proposed the Joint Reorganization Plan of PSA, Inc., ETS Payphones, Inc., and ETS Vending, et al. dated June 11, 2001 as amended on July 25, 2001 and filed the Disclosure Statement in support thereof (the "Joint Plan"); and the Bankruptcy Court having entered (a) an Order dated July 27, 2001 approving the Disclosure Statement (the "Disclosure Statement Order"), (b) an order dated July 27, 2001 scheduling a hearing on confirmation of the Joint Plan (the "Confirmation Hearing") and approving the form and manner of notice related thereto (the "Scheduling Order"), and (c) an order dated August 31, 2001 continuing the Confirmation Hearing, providing for supplemental disclosure and an opportunity

[1] Unless otherwise specified, capitalized terms and phrases used herein have the meanings assigned to them in the Joint Plan (as defined herein). The rules of interpretation set forth in Article I, Section B of the Joint Plan shall apply to these Findings of Fact, Conclusions of Law and Order (this "Confirmation Order"). In addition, in accordance with Article I, Section A of the Joint Plan, any term used in the Joint Plan or this Confirmation Order that is not defined in the Joint Plan or this Confirmation Order, but that is used in the Bankruptcy Code or the Bankruptcy Rules, shall have the meaning given to that term in the Bankruptcy Code or the Bankruptcy Rules, as applicable. In accordance with Article I, Section B of this Confirmation Order, if there is any direct conflict between the terms of the Joint Plan and the terms of this Confirmation Order, the terms of this Confirmation Order shall control.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE:	)	
	)	CASE NO. 00-3570 (EIK)
PSA, INC.,	)	
ETS PAYPHONES, INC.,	)	CHAPTER 11
ETS VENDING, INC., ET AL.	)	(JOINTLY ADMINISTERED
	)	Case Nos. 00-3570 through
	)	00-3572 and 00-3718 through
Debtors.	)	00-3725)

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER CONFIRMING THE JOINT REORGANIZATION PLAN OF PSA, INC, ETS PAYPHONES, INC. AND ETS VENDING, INC., ET AL.

Debtors having filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101-1330 (as amended and supplemented, the "Bankruptcy Code"), on September 11 and 21, 2001; and Debtors and the Official Committee of Unsecured Creditors (the "Creditors' Committee"),[1] having proposed the Joint Reorganization Plan of PSA, Inc., ETS Payphones, Inc., and ETS Vending, et al. dated June 11, 2001 as amended on July 25, 2001 and filed the Disclosure Statement in support thereof (the "Joint Plan"); and the Bankruptcy Court having entered (a) an Order dated July 27, 2001 approving the Disclosure Statement (the "Disclosure Statement Order"), (b) an order dated July 27, 2001 scheduling a hearing on confirmation of the Joint Plan (the "Confirmation Hearing") and approving the form and manner of notice related thereto (the "Scheduling Order"), and (c) an order dated August 31, 2001 continuing the Confirmation Hearing, providing for supplemental disclosure and an opportunity

[1] Unless otherwise specified, capitalized terms and phrases used herein have the meanings assigned to them in the Joint Plan (as defined herein). The rules of interpretation set forth in Article I, Section B of the Joint Plan shall apply to these Findings of Fact, Conclusions of Law and Order (this "Confirmation Order"). In addition, in accordance with Article I, Section A of the Joint Plan, any term used in the Joint Plan or this Confirmation Order that is not defined in the Joint Plan or this Confirmation Order, but that is used in the Bankruptcy Code or the Bankruptcy Rules, shall have the meaning given to that term in the Bankruptcy Code or the Bankruptcy Rules, as applicable. In accordance with Article I, Section B of this Confirmation Order, if there is any direct conflict between the terms of the Joint Plan and the terms of this Confirmation Order, the terms of this Confirmation Order shall control.

for Payphone Investors to recast ballots with respect to the Joint Plan (the "Supplemental Disclosure Order"); and Debtors and Creditors' Committee having filed the Affidavit of Poorman-Douglas Corporation certifying tabulation of votes with respect to the Joint Plan on August 31, 2001 and the Amended Affidavit of Poorman-Douglas Corporation certifying tabulation of votes with respect to the Joint Plan after providing the Payphone Investors an opportunity to recast their ballots (collectively, the "Voting Declaration"); and Debtors and Creditors' Committee having complied with the notice requirements as set forth in the Scheduling Order and Supplemental Disclosure Order; and the Bankruptcy Court having established August 31, 2001 at 9:00 a.m., Eastern Time, as the date and time of the Confirmation Hearing; and objections to confirmation of the Joint Plan having been timely filed and/or served by August 24, 2001; and Debtors and Creditors' Committee having filed a memorandum of law in support of confirmation of the Joint Plan (the "Memorandum of Law"); and the Bankruptcy Court having reviewed the Joint Plan, the Disclosure Statement, the Disclosure Statement Order, the Scheduling Order, the Supplemental Disclosure Order and the supplemental disclosure made pursuant thereto, the Voting Declaration, the Memorandum of Law and the other papers before the Bankruptcy Court; and the Bankruptcy Court having heard the statements of counsel in relation to confirmation at the Confirmation Hearing and testimony of Debtors' Chief Executive Officer, Guy A. Longobardo, as reflected in the record at the Confirmation Hearing; and the Bankruptcy Court having considered all testimony presented and evidence admitted at the Confirmation Hearing; and the Bankruptcy Court finding that: (i) notice of the Confirmation Hearing and the opportunity of any party in interest to object to confirmation was adequate and appropriate, in accordance with Bankruptcy Rule 2002(b), as to all parties to be affected by the Joint Plan and the transactions contemplated thereby; (ii) Debtors and Creditors' Committee

having complied with the noticing requirements set forth in the Scheduling Order and Supplemental Disclosure Order; and (iii) the legal and factual bases set forth in the Memorandum of Law and at the Confirmation Hearing, and as set forth in this Confirmation Order, establish just cause for the relief granted herein; the Bankruptcy Court hereby makes the following Findings of Fact, Conclusions of Law and Order.[2]

I. FINDINGS OF FACT AND CONCLUSIONS OF LAW.

A. Jurisdiction and Venue.

On September 11 and 21, 2000 (the "Petition Date") Debtors commenced their respective cases by filing voluntary petitions for relief under chapter 11 of the Bankruptcy Code. The Bankruptcy Court has jurisdiction over the Chapter 11 Cases pursuant to 28 U.S.C. §§ 157 and 1334. Confirmation of the Joint Plan is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(L) over which the Bankruptcy Court has jurisdiction. Pursuant to 28 U.S.C. §§ 1408 and 1409, venue for the Chapter 11 Cases in the United States Bankruptcy Court for the District of Delaware was proper as of the Petition Date and continues to be proper.

[2] This Confirmation Order constitutes the Bankruptcy Court's findings of fact and conclusions of law under FED. R. CIV. P. 52, as made applicable by Bankruptcy Rules 7052 and 9014. Any finding of fact shall constitute a finding of fact even if it is stated as a conclusion of law, and any conclusion of law shall constitute a conclusion of law even if it is stated as a finding of fact.

B. Compliance with the Requirements of Section 1129(a) of the Bankruptcy Code.

1. Section 1129(a)(1) -- Compliance of the Joint Plan with Applicable Provisions of the Bankruptcy Code.

The Joint Plan complies with all applicable provisions of the Bankruptcy Code, as required by section 1129(a)(1) of the Bankruptcy Code, including sections 1122 and 1123 of the Bankruptcy Code.

a. Sections 1122 and 1123(a)(1) (4) -- Classification and Treatment of Claims and Interests.

As required by sections 1122(a) and 1123(a)(1) of the Bankruptcy Code, Article II of the Joint Plan designates Classes of Claims and Interests, other than Administrative Claims and Tax Claims.[3] Other claims against Debtors are classified separately in Classes 1 through 7. Interests in ETS Payphones, Inc. are classified separately in Class 8. As required by section 1122(a), each class of Claims and Interests contains only Claims or Interests that are substantially similar to the other Claims or Interests within that class. Such classification is proper under section 1122(a) because each Claim in each class of Claims is substantially similar to the other Claims in such class and each Interest is substantially similar to the other Interests in such Class. The Joint Plan places all Claims against Debtors in Classes 1 through 5, regardless of whether such claims are against a single Debtor or Multiple Debtors. Such classification is proper under the facts and circumstances of the Joint Plan and these Chapter 11 Cases. In accordance with sections 1123(a)(2) and (3) of the Bankruptcy Code, Article III of the Joint Plan specifies all classes of Claims and Interests that are not impaired under the Joint Plan. Article III of the Joint Plan also specifies the treatment of all classes of Claims and Interests that are

impaired under the Joint Plan. In accordance with section 1123(a)(4) of the Bankruptcy Code, Article III of the Joint Plan also provides the same treatment for each Claim or Interest within a particular class, unless the Holder of a Claim or Interest agrees to less favorable treatment of its Claim or Interest.

b. Section 1123(a)(5) - Adequate Means for Implementation of the Joint Plan.

Articles IV through VIII and various other provisions of the Joint Plan provide adequate means for the Joint Plan's implementation. Those provisions relate to, among other things: (i) the cancellation of Old Stock; (ii) the issuance of Reorganized ETS Stock in partial satisfaction of the Claims of Holders of Class 4 Payphone Investor Claims; (iii) the establishment of a Litigation Trust to pursue various claims and causes of action for the benefit of the Holders of Class 3 and Class 4 Claims; (iv) resolution of the Declaratory Judgment Action; (v) the vesting of Debtors' property in Reorganized ETS; (vi) the appointment of the Board of Directors of Reorganized ETS; and (vii) the substantive consolidation of all Debtors into one reorganized entity. The Joint Plan provides adequate means for its implementation, thereby satisfying section 1123(a)(5) of the Bankruptcy Code.

c. Section 1123(a)(6) - Prohibition Against the Issuance of Nonvoting Equity Securities.

Article IV of the Joint Plan provides for the inclusion in the Articles of Incorporation and By-laws of Reorganized ETS of a provision prohibiting the issuance of non-voting equity securities. Accordingly, the Joint Plan satisfies the requirement of section 1123(a)(6) of the Bankruptcy Code that a plan prohibit the issuance of any nonvoting securities.

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[3] Pursuant to section 1123(a)(1) of the Bankruptcy Code, classes of Administrative Claims and Priority Tax Claims are not required to be designated.

d. Section 1123(a)(7) -- Selection of Directors and Officers in a Manner Consistent with the Interests of Creditors and Equity Security Holders and Public Policy.

Article IV(M) of the Joint Plan provides for three initial directors of Reorganized Debtors, who shall begin serving on the Effective Date, with the ability of the Creditors' Committee to name two additional directors prior to the Effective Date. The Creditors' Committee consists of three Payphone Investors and two Holders of Class 3 General Unsecured Claims. Because Distributions to the Payphone Investors and General Unsecured Creditors are dependent upon future profitability of Reorganized ETS, the Creditors' Committee's selection of the initial Board of Directors is consistent with the interests of the Holders of Claims and public policy and satisfies section 1123(a)(7).

2. *Section 1129(a)(2) - Compliance with Applicable Provisions of the Bankruptcy Code.*

Debtors and Creditors' Committee have complied with all applicable provisions of the Bankruptcy Code, as required by section 1129(a)(2) of the Bankruptcy Code, including section 1125 of the Bankruptcy Code and Bankruptcy Rules 3017 and 3018 and the Solicitation Procedures Order entered July 27, 2001. The Disclosure Statement, the Summary Disclosure Statements and the procedures by which the ballots for acceptance or rejection of the Joint Plan were solicited and tabulated were fair, properly conducted and in accordance with section 1126 of the Bankruptcy Code and Bankruptcy Rule 3018.

3. Section 1129(a)(3) -- Proposal of the Joint Plan in Good Faith.

Debtors and Creditors' Committee proposed the Joint Plan in good faith and not by any means forbidden by law. In determining that the Joint Plan has been proposed in good faith, the Bankruptcy Court has examined the totality of the circumstances surrounding the formulation of the Joint Plan. Based on the uncontroverted evidence presented at the Confirmation Hearing, the Bankruptcy Court finds and concludes that the Joint Plan has been proposed with the legitimate and honest purpose of reorganizing Debtors and maximizing the returns available to Holders of Allowed Claims against Debtors. Moreover, the Joint Plan itself, and the arms' length negotiations between Debtors and the Creditors' Committee leading to the Joint Plan's formulation, as well as the overwhelming support of creditors for the Joint Plan, provide independent evidence of Debtors' good faith in proposing the Joint Plan.

4. Section 1129(a)(4) - Bankruptcy Court Approval of Certain Payments as Reasonable.

The amount and nature of Administrative Claims incurred by Debtors in the ordinary course of business are reasonable and no further disclosure is required. Article IV of the Joint Plan provides that Professionals or other entities asserting a Professional Fee Claim, Substantial Contribution Claims or other Administrative Claims for services rendered or goods provided before the Confirmation Date must file and serve on Debtors and their counsel an application for final allowance of such Claim which the Court will review for reasonableness. Therefore, all payments made or to be made by Debtors for services, costs or expenses incurred in, or in connection with, the Chapter 11 Cases, or in connection with the Joint Plan and incident to the Chapter 11 Cases, have been disclosed and are reasonable (or subject to approval by this Court). Accordingly, the Joint Plan satisfies section 1129(a)(4).

5. Section 1129(a)(5) -- Disclosures Regarding Proposed Directors and Officers, and Compensation of Insiders and Consistency with the Interests of Creditors and Public Policy.

Debtors and Creditors' Committee, as proponents of the Joint Plan, have disclosed the identity and affiliations of the individuals proposed to serve, after Confirmation of the Joint Plan, as directors and officers of the Reorganized ETS, and the appointments to and continuance in such offices of such individuals are consistent with the interests of Creditors and Interest Holders and with public policy. Debtors and Creditors' Committee, as proponents of the Joint Plan, have also disclosed the identity of all insiders that will be employed or retained by Reorganized ETS, and the nature of any compensation for such insider. Therefore, the Joint Plan satisfies the requirements of section 1129(a)(5) of the Bankruptcy Code.

6. Section 1129(a)(6) –Approval of Rate Changes.

The Joint Plan does not change rates over which any regulatory commission has or will have jurisdiction after Confirmation. Section 1129(a)(6) is inapplicable to Confirmation.

7. Section 1129(a)(7) – Best Interests of Holders of Claims and Interests.

With respect to each impaired class of Claims and Interests, each Holder of a Claim in such impaired Class has accepted the Joint Plan or, as demonstrated by the Disclosure Statement and other evidence presented at the Confirmation Hearing, will receive or retain under the Joint Plan on account of such Claim property of a value as of the Effective Date that is not less than the amount such Holder would receive or retain if Debtors were liquidated on the Effective Date under chapter 7 of the Bankruptcy Code. Accordingly, the Joint Plan satisfies section 1129(a)(7) of the Bankruptcy Code.

8. Section 1129(a)(8) - Acceptance of the Joint Plan by Each Impaired Class.

As set forth in detail in the Voting Declaration, Class 3 and Class 4 accepted the Joint Plan by the requisite majorities in amount and number. Specifically, of the 517 Holders representing $1,055,970.77 of Class 3 General Unsecured Claims actually voting, votes representing $1,046,968.81 dollars of claims voted to accept the Joint Plan, which represents an acceptance rate in excess of ninety-nine percent (99%). Of the 8,398 Holders of Class 4 Payphone Investor Claims actually voting, 8099 voted to accept the Joint Plan, which represents an acceptance rate of ninety-six percent (96%) by number, or ninety-five percent (95%) by dollar amount, when the formula set forth in the Disclosure Statement is applied to these Claims. The acceptance of the Joint Plan by the Payphone Investors in Class 4 remained the same even after having an opportunity to recast their ballots.

Because they will receive no property or other distribution under the Joint Plan, the Holders of Class 5 Subordinated Claims, Class 6 Intercompany Claims, Class 7 Non-Debtor Affiliate Claims, and Class 8 Interests in ETS are conclusively presumed to have rejected the Joint Plan. As a result, the Joint Plan does not comply with section 1129(a)(8). Debtors have invoked the "cramdown" requirements of section 1129(b) with respect to each of these classes. As discussed below, the Joint Plan satisfies each of the cramdown requirements.

9. Section 1129(a)(9) - Treatment of Claims Entitled to Priority Pursuant to Section 507(a) of the Bankruptcy Code.

Article III of the Joint Plan provides for treatment of allowed Administrative Claims, Priority Tax Claims and other Priority Claims in the manner required by section 1129(a)(9) of the Bankruptcy Code, except to the extent that the Holder of a particular

Administrative Claim, Tax Claim or Priority Non-Tax Claim agrees to different treatment. Resolution of the objections filed by various taxing authorities is summarized on Exhibit B.

10. Section 1129(a)(10) - Acceptance By at Least One Impaired Class.

As indicated in the Voting Declaration and as reflected in the record of the Confirmation Hearing, Classes 3 and 4 are impaired under the Joint Plan and have accepted the Joint Plan, determined without including any acceptance of the Joint Plan by any insiders in such classes. Therefore, the Joint Plan satisfies section 1129(a)(9).

11. Section 1129(a)(11) - Feasibility of the Joint Plan.

As established by the Disclosure Statement and in evidence at the Confirmation Hearing and in the Memorandum of Law, Debtors and Creditors' Committee have demonstrated that Confirmation of the Joint Plan is not likely to be followed by the liquidation or the need for further financial reorganization of the Debtors. Without limiting the foregoing, the Bankruptcy Court finds that Debtors and Creditors' Committee have demonstrated a reasonable likelihood that Debtors and Reorganized ETS will have, after various sales and other sources, sufficient liquidity to operate the business in the ordinary course and to satisfy their obligations under the Joint Plan. Accordingly, the Joint Plan satisfies the feasibility requirement of section 1129(a)(11) of the Bankruptcy Code.

12. Section 1129(a)(12) -- Payment of Bankruptcy Fees.

Article IV(U) of the Joint Plan provides that all fees payable pursuant to 28 U.S.C. § 1930 will be paid on or before the Distribution Date.

13. Section 1129(a)(13) -- Retiree Benefits.

Debtors have no "retiree benefits" as defined in section 1114(a) of the Bankruptcy Code. Section 1129(a)(13) is inapplicable to confirmation.

C. Compliance with Section 1129(b) of the Bankruptcy Code.

Pursuant to section 1129(b)(1) of the Bankruptcy Code, the Joint Plan is confirmed, notwithstanding that the Claims and Interests classified in Classes 5, 6, 7 and 8 are Impaired, and that such Holders are deemed to have rejected the Joint Plan pursuant to section 1126(g) of the Bankruptcy Code. The Joint Plan does not discriminate unfairly and is fair and equitable with respect to the Holders of Claims and Interests in such Classes. No Holder of Claims or Interests junior to the Holder of Class 4 Payphone Investor Claims will receive or retain any property under the Joint Plan on account of such junior Claims or Interests. Because the value of Reorganized ETS as of the Effective Date is substantially less than the liabilities of Debtors, the Joint Plan does not discriminate unfairly and is fair and equitable with respect to Class 8 Interests.

D. Section 1129(d) -- Purpose of Joint Plan.

The primary purpose of the Joint Plan is not avoidance of taxes or avoidance of the requirements of Section 5 of the Securities Act, and there has been no objection filed by any governmental unit asserting such avoidance.

E. Satisfaction of Conditions to Confirmation.

Each of the conditions precedent to the entry of this Confirmation Order has been satisfied.

F. Compliance with Section 1125(e) of the Bankruptcy Code.

Pursuant to section 1125(e) of the Bankruptcy Code, Debtors' and Creditors' Committee solicitation of acceptances of the Joint Plan were in good faith and in compliance with applicable provisions of the Bankruptcy Code. Accordingly, Debtors and their respective directors, officers, employees, members of Creditors' Committee, agents and professionals

retained with the approval of the Bankruptcy Court (acting in such capacity) are entitled to the protection of section 1125(e) of the Bankruptcy Code.

G. Exemptions From Taxation.

Pursuant to section 1146(c) of the Bankruptcy Code: (1) the creation of any mortgage, deed of trust, lien, or other security interest; (2) the making or assignment of any lease or sublease; or (3) the making or delivery of any deed or other instrument of transfer under, in furtherance of, or in connection with the Joint Plan, including any restructuring, will not be subject to any stamp tax, real estate transfer tax or similar tax and the appropriate state or local governmental officials or agents shall be, and hereby are, directed to forego the collection of any such tax or governmental assessment and to accept for filing and recordation any of the foregoing instruments or other documents without the payment of any such tax or governmental assessment.

H. Corporate Issues.

Debtors and Creditors' Committee have disclosed all material facts regarding: (1) the selection of the directors and officers of Reorganized Debtors; (2) the distribution of Cash pursuant to the Joint Plan; (3) the substantive consolidation of Debtors after the Effective Date; and (4) the other matters provided for under the Joint Plan involving the corporate structure of any Debtor or corporate action to be taken by or required of any Debtor.

I. Liquidation Analysis.

The Liquidation Analysis in the Disclosure Statement was accurate at the time prepared, no material events have transpired which would alter the analysis and the analysis was based on reasonable and sound business assumptions. The Liquidation Analysis provides a reasonable estimate of liquidation value under a hypothetical chapter 7.

J. **Assumptions of Executory Contracts and Unexpired Leases.**

Each pre- or post-Confirmation assumption of an executory contract or unexpired lease pursuant to Article VII of the Joint Plan shall be legal, valid and binding upon the applicable Debtors and all non-Debtor parties to such executory contract or unexpired lease, all to the same extent as if such assumption had been effectuated pursuant to an appropriate authorizing order of the Bankruptcy Court entered before the Confirmation Date under section 365 of the Bankruptcy Code.

II. ORDER.

ACCORDINGLY, THE COURT HEREBY ORDERS, ADJUDGES AND DECREES THAT:

1. **Confirmation of the Joint Plan.**

The Joint Plan shall be and hereby is confirmed in each and every respect pursuant to section 1129 of the Bankruptcy Code. A copy of the Joint Plan is attached hereto as Exhibit A. Any modifications to the Joint Plan as approved by the Bankruptcy Court at the Confirmation Hearing shall be, and hereby is, approved and incorporated into and made part of the Joint Plan. Each and every provision of the Joint Plan is incorporated into and made an integral part of this Confirmation Order as if the Joint Plan were set forth entirely in this paragraph.

2. **Objections Overruled; Confirmation of the Joint Plan.**

To the extent that any objections to confirmation of the Joint Plan have not been withdrawn or otherwise disposed of on or before the date hereof, all such objections shall be, and hereby are, overruled and all withdrawn objections shall be, and hereby, are deemed withdrawn

with prejudice. Debtors have resolved the objections of various taxing authorities as set forth in the Notice of Proposed Tax Settlements. In addition, Debtors have resolved the objection of United Payphone Owners LLP as stated in the record at the Confirmation Hearing and as described in the Motion to Approve Settlement currently pending before this Court.

3. **Effects of Confirmation.**

a. Immediate Effectiveness; Successors and Assigns.

Pursuant to Bankruptcy Rule 9014, Bankruptcy Rule 7062 shall not apply to this Order. Subject to the foregoing and the provisions of Article IX of the Joint Plan, and notwithstanding any otherwise applicable law, immediately upon the entry of this Confirmation Order, pursuant to section 1141 of the Bankruptcy Code the terms of the Joint Plan and this Confirmation Order shall be, and hereby are, deemed binding upon Debtors, any and all Holders of Claims or Interests (irrespective of whether such Claims or Interests are unimpaired under the Joint Plan or whether the Holders of such Claims or Interests accepted, rejected or are deemed to have accepted or rejected the Joint Plan), any and all non-debtor parties to executory contracts and unexpired leases with any Debtors and the respective heirs, executors, administrators, successors or assigns, if any, of any of the foregoing, all subject to the recurrence of the Effective Date.

b. Cancellation of Equity Securities.

On the Effective Date, all equity securities of ETS Payphones, Inc. shall be, and hereby are, canceled and of no further force and effect without the need for any further action on the part of any Debtor. The Holders of or parties to such canceled instruments, securities and other documentation shall have no rights arising from or relating to such instruments, securities and other documentation or the cancellation thereof other than as set forth in the Joint Plan.

c. Issuance of Reorganized ETS Stock

Pursuant to section 1145(a) of the Bankruptcy Code, the issuance of Reorganized ETS Stock by Reorganized ETS and interests in the Litigation Trust pursuant to the Joint Plan shall not be subject to the registration requirements of Section 5 of the Securities Act of 1933. Pursuant to Bankruptcy Code section 1146(c), the issuance of Reorganized ETS Stock by Reorganized ETS is exempt from taxation by state and local entities.

d. Discharge of the Debtors and Injunction

All consideration distributed under the Joint Plan shall be in exchange for, and in complete satisfaction, settlement, discharge, and release of, all Claims of any nature whatsoever against any Debtor or against any of its assets or properties arising on or before the Effective Date. Except as otherwise expressly provided in the Joint Plan or in this Confirmation Order, entry of the Confirmation Order shall act as a discharge of all Claims against, and Interests in, each of Debtors, such Debtor's assets, and its respective properties, arising at any time before the entry of the Confirmation Order, regardless of whether a proof of Claim therefor was filed, whether the Claim is Allowed, or whether the Holder thereof votes to accept the Joint Plan or is entitled to receive a Distribution thereunder. Upon entry of this Confirmation Order, any Holder of such discharged Claim or Interest shall be precluded from asserting against any of Debtors or any of its assets or properties any other or further Claim or Interest based upon any document, instrument, act, omission, transaction, or other activity of any kind or nature that occurred the Effective Date. This Confirmation Order shall be a judicial determination of discharge of all liabilities of Debtors, subject to the occurrence of the Effective Date.

In accordance with section 524 of the Bankruptcy Code, the discharge provided by this section and section 1141 of the Bankruptcy Code shall act as an injunction against the

commencement or continuation, in any manner or in any place, of any action, employment of process, or act to collect, offset, or recover the Claims and Interests discharged by the Joint Plan. Except as otherwise expressly provided in the Joint Plan or in the Confirmation Order, all Persons who have held, hold, or may hold Claims against, or Interests in, any of Debtors are permanently enjoined, on and after the Effective Date, from taking any of the following actions against any Debtor, any Estate, Reorganized ETS, the United States Trustee, or any of their property on account of any such Claims or Interests: (i) commencing or continuing in any manner or in any place, action, or other proceeding of any kind with respect to any such Claim or Interest, (ii) enforcing, attaching, collecting, or recovering in any manner or means any judgment, award, decree, or order on account of any such Claim or Interest, (iii) creating, perfecting, or enforcing any lien or encumbrance of any kind, (iv) asserting any right of setoff, subrogation, or recoupment of any kind against any debt, liability, or obligation due from any Debtor or against the property or interests in property of any Debtor on account of any such Claim or Interest, and (v) commencing or continuing, in any manner or in any place that does not comply with or is inconsistent with the provisions of the Joint Plan; provided, however, that nothing contained in the Joint Plan shall preclude such Persons from exercising their rights pursuant to and consistent with the terms of the Joint Plan. The foregoing injunction shall extend to successors of Debtors (including, without limitation, Reorganized ETS) and their respective properties and interests in property. Reorganized ETS shall not be a successor to any liabilities of Debtors.

e. Exculpation

The Debtors, their officers, employees on the Confirmation Date, members of Creditors' Committee appointed in these Chapter 11 Cases, and professionals retained with

approval of the Bankruptcy Court in these Chapter 11 Cases shall not have or incur any liability to any person for any act taken or omission occurring on or after the Petition Date in connection with or related to the Debtors, included, but not limited to:

(i) the commencement and administration of the Chapter 11 Cases,

(ii) the operation of the Debtors during the pendency of the Chapter 11 Cases

(iii) formulating, preparing, disseminating, implementing, confirming, consummating or administering the Joint Plan (including solicitation of acceptances or rejections);

(iv) the Disclosure Statement or any contract, instrument, settlement or other agreement or document entered into or any taking taken or omitted to be taken with the Joint Plan; or

(v) any distributions made pursuant to the Joint Plan;

except for acts (a) constituting willful misconduct or gross negligence, and in all respects such parties shall be entitled to rely upon the advice of counsel with respect to their duties and responsibilities in these Chapter 11 Cases; and (b) that are the subject of any action or proceeding pending as of the Effective Date.

f. Dissolution of the Creditors' Committee

On the Effective Date, Creditors' Committee shall be dissolved and its members will be deemed released of all their duties, responsibilities, and obligations in connection with the Chapter 11 Cases or the Joint Plan and its implementation, and the retention or employment of Creditors' Committee's attorneys, accountants, and other agents shall terminate.

4. Administrative Claims Bar Date.

All applications for payment of Administrative Claims and expenses incurred on or before the Confirmation Date under sections 507(a)(i) or 507(b) of the Bankruptcy Code (except for claims incurred in the ordinary course of business, claims under 28 U.S.C. § 1930

and claims of court-approved professionals) shall be filed and served on Debtors' and Creditors' Committee Counsel no later than 45 days after the Date of this Order. Professionals or other entities asserting a Professional Fee Claim for services rendered after the Confirmation Date must file and serve on Debtors and their counsel an application for final allowance of such Professional Fee claim no later than 60 days after the Effective Date. Objections to these claims will be governed by Article IV, Section C of the Joint Plan. The Compensation Estimate provisions and reserves therefor set forth in the Joint Plan are specifically approved.

5. Matters Relating to Implementation of the Joint Plan.

a. Implementation.

Prior to the occurrence of the Effective Date, Debtors (and following the Effective Date, Reorganized ETS) and their directors, officers and representatives shall be and hereby are authorized and empowered to take all actions necessary or appropriate to consummate the transactions contemplated by the Joint Plan and to perform thereunder.

b. Substantive Consolidation.

Debtors shall be substantively consolidated as follows: (i) all assets and liabilities of Debtors shall be deemed merged or treated as though they were merged into and with the assets and liabilities of ETS Payphones, Inc.; (ii) no distributions shall be made under the Joint Plan on account of intercompany claims among Debtors; (iii) no distributions shall be made under the Joint Plan on account of Interests in Debtor Affiliates; (iv) all guarantees by any of Debtors of the obligations of any other Debtor arising prior to the Effective Date shall be deemed eliminated so that any Claim against any Debtor and any guarantee thereof executed by any other Debtor and any joint or several liability of any of Debtors shall be deemed to be one obligation of Reorganized ETS; and (v) each and every Claim filed or to be filed in the Chapter 11 Case of

any of Debtors shall be deemed filed against the consolidated Debtors, and shall be deemed one Claim against and obligation of the consolidated Debtors. On the Confirmation Date, all assets and liabilities of each Debtor shall be substantively consolidated.

c. Injunctions and Stays Remain in Effect until Effective Date.

All injunctions and stays pursuant to sections 105 and 362 of the Bankruptcy Code or otherwise shall remain in full force and effect until the Effective Date of the Joint Plan, except that nothing herein shall bar the taking of such actions as are necessary to effectuate the transactions specifically contemplated by the Joint Plan or this Confirmation Order prior to the Effective Date. Subsequent to the Effective Date, all such injunctions and stays shall cease and be of no further force or effect, without further order of the Bankruptcy Court being necessary.

d. Revesting of Assets.

On the Effective Date, the property of each of the Estates, together with any property of a Debtor that is not property of its Estate and that is not specifically disposed of pursuant to the Joint Plan, shall revest in and/or otherwise become property or an asset of Reorganized ETS without the need for any further Bankruptcy Court order or act by Debtors or Reorganized ETS. Thereafter, Reorganized ETS may operate its business and may use, acquire, and dispose of property free of any restrictions of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, and the Bankruptcy Court. As of the Effective Date, all property of Debtors shall be free and clear of all claims and interests, except as specifically provided in the Joint Plan or the Confirmation Order. All licenses, franchises, certificates, automatic number identifiers, operating permits and other licenses owned by Debtors shall become property of and be transferred to Reorganized ETS without further order of the Bankruptcy Court.

e. Corporate Action.

On the Effective Date, the adoption of the Articles of Incorporation or similar constituent documents and the By-Laws, the selection of directors and officers for the Reorganized ETS, and all actions contemplated by the Joint Plan shall be, and hereby are, authorized and approved in all respects (subject to the provisions of the Joint Plan). All matters provided for in the Joint Plan involving the corporate structure of Debtors or Reorganized ETS, any corporate action required by Debtors or Reorganized ETS in connection with the Joint Plan shall be, and hereby are, deemed to have occurred and be effective as provided in the Joint Plan, and shall be, and hereby are, authorized and approved in all respects without any requirement of further action by any Person or entity.

f. Management of Reorganized Debtors.

On and after the Effective Date, the board of directors of Reorganized ETS shall have the responsibility for the management, control and operation of Reorganized ETS.

g. Approval of Executory Contract and Unexpired Lease Provisions.

(i) The executory contract and unexpired lease provisions of Article XVIII of the Joint Plan shall be, and hereby are, specifically approved and incorporated herein by this reference. The Bankruptcy Court authorizes the assumption of executory contracts and unexpired leases described on Schedule 1 of the Joint Plan (as amended up to the Effective Date) as of the Effective Date, and the Court authorizes the rejection of the executory contracts and unexpired leases set forth on Schedule 2 of the Joint Plan. Parties to executory contracts and unexpired leases rejected by the Confirmation Order, or any subsequent order entered prior to the Effective Date shall have thirty (30) days from the entry thereof to file any and all Claims arising from the rejection of such contract or lease.

(ii) Executory contracts and unexpired leases entered into or assumed and other obligations incurred after the Petition Date by any Debtor shall be performed by Reorganized ETS in the ordinary course of its business. Accordingly, such executory contracts and unexpired leases and other obligations shall survive and remain unaffected by entry of this Confirmation Order.

h. Distributions.

Reorganized ETS shall make all distributions required under the Joint Plan in accordance with the terms and provisions of the Joint Plan. Notwithstanding any other provision of the Joint Plan or this Confirmation Order, each Person or entity that has received any distribution pursuant to the Joint Plan shall, and hereby does, have sole and exclusive responsibility for the satisfaction and payment of any tax obligation imposed by any governmental unit, including income, withholding and tax obligations, on account of such distribution.

Disbursing Agent shall receive from Reorganized ETS reasonable compensation for such services and reimbursement of reasonable out-of-pocket expense incurred in connection with such services pursuant without the need for any further approval by this Bankruptcy Court. All funds and shares of Reorganized ETS stock held or maintained in reserve by Reorganized ETS as Disbursing Agent shall be deemed to be held in trust for the benefit of holders of allowed claims, and shall be free and clear of all liens, claims and encumbrances otherwise affecting Reorganized ETS.

In accordance with section 553 of the Bankruptcy Code, Reorganized ETS or Debtors may set off against any Allowed Claim and the distributions to be made on account of such Claim provided, however, that neither the failure to effect such a setoff nor the allowance of

any Claim shall constitute a waiver or release by Debtors or Reorganized ETS of any such claims, rights and causes of action that Debtors or Reorganized ETS may possess against such Holder.

i. Litigation Trust

The terms and conditions of the Litigation Trust Agreement annexed to the Plan Supplement are hereby authorized and approved.

6. Actions in Furtherance of the Joint Plan.

The approvals and authorizations specifically set forth in this Confirmation Order are nonexclusive and are not intended to limit the authority of Reorganized ETS or any officer thereof to take any and all actions necessary or appropriate to implement, effectuate and consummate any and all documents or transactions contemplated by the Joint Plan or this Confirmation Order. In addition to the authority to execute and deliver, adopt or amend, as the case may be, the contracts, leases, instruments, releases and other agreements specifically granted in this Confirmation Order, Reorganized ETS shall be, and hereby is, authorized and empowered to take any and all such actions as any of their officers may determine are necessary or appropriate to implement, effectuate and consummate any and all documents or transactions contemplated by the Joint Plan or this Confirmation Order.

7. Special Provisions Regarding Entry of a Final Decree Closing the Chapter 11 Cases.

It is contemplated that as soon as practicable after the completion of all distributions under the Joint Plan, this Court shall be able to enter a final decree closing the Chapter 11 Cases.

8. Retention of Jurisdiction.

Notwithstanding the entry of this Confirmation Order or the occurrence of the Effective Date, the Bankruptcy Court shall retain such jurisdiction over the Chapter 11 Cases as is legally permissible, including jurisdiction over the matters set forth in the Joint Plan, which provisions are incorporated herein by reference.

9. Notice Of Entry Of Confirmation Order.

Pursuant to Bankruptcy Rules 2002(f)(7) and 3020(c), Debtors shall be, and hereby are, directed to serve a notice of the entry of this Confirmation Order and the establishment of bar dates, substantially in the form of Exhibit B attached hereto and incorporated herein by reference (the "Confirmation Notice"), on all parties in interest, no later than 15 days after the Confirmation Date; provided, however, that Debtors shall be obligated to serve the Confirmation Notice only on the record holders of Claims or Interests as of the Confirmation Date.

Dated: Wilmington, Delaware, November 14, 2001

Erwin I. Katz

THE HONORABLE ERWIN I. KATZ,
UNITED STATES BANKRUPTCY JUDGE

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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

2001 JUL 25 PM 3:10

IN RE:	CASE NO. 00-3570 (JCA)
PSA, INC., ETS PAYPHONES, INC., ETS VENDING, INC., ET AL.,	CHAPTER 11 (JOINTLY ADMINISTERED Case Nos. 00-3570 through 00-3572 and 00-3718 through 00-3725)
Debtors.	

FIRST AMENDED JOINT REORGANIZATION PLAN SUBMITTED BY THE DEBTORS AND THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS

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7/25/01

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2	Schedule of Rejected Leases and Executory Contracts
3	Articles of Incorporation of Reorganized ETS, Inc.
4	By-laws of Reorganized ETS, Inc.
5	Management Employment Agreements
	5.1 Mr. Guy A. Longobardo
	5.2 Mr. Michael H. McClellan

INTRODUCTION

ETS Payphones, Inc.; PSA, Inc.; ETS Vending, Inc., ETS Management, LLC; Americom, Inc.; City Public Phones, Inc.; ETS Payphones of California, Inc.; MSC National, Inc.; S and R Telecommunications Consultants, Inc.; TSC Payphone Corp.; and Phoenix Telecom of Puerto Rico, Inc., the debtors and debtors in possession, (the "Debtors") and the Official Committee of Unsecured Creditors (the "Creditors' Committee") jointly propose the following Joint Reorganization Plan (the "Joint Plan") for the resolution and full satisfaction and discharge of all Claims against and Interests in Debtors. Reference is made to the Disclosure Statement with respect to this Joint Plan for a discussion of, among other things, Debtors' history, businesses, properties, results of operations and projections for future operations, and for a summary and analysis of this Joint Plan and certain related matters. Debtors and the Creditors' Committee are the proponents of this Joint Plan within the meaning of section 1129 of the Bankruptcy Code. All Holders of Claims against and Interests in Debtors entitled to vote on this Joint Plan are encouraged to read this Joint Plan and the Disclosure Statement in their entirety before voting to accept or reject this Joint Plan. Subject to certain restrictions and requirements set forth in this Joint Plan, Debtors and Creditors' Committee reserve the right to alter, amend, modify, revoke or withdraw this Joint Plan prior to its consummation.

ARTICLE I

DEFINITIONS, RULES OF INTERPRETATION, COMPUTATION OF TIME AND GOVERNING LAW

A. Definitions

For purposes of this Joint Plan, each capitalized term used herein shall have the meaning set forth below.

1. *Adjusted Amount* means, with respect to a Disputed Claim, (a) to the extent such Disputed Claim is a liquidated Claim, the maximum Face Amount of such Disputed Claim as asserted in the relevant proof of Claim or such other amount as the Bankruptcy Court shall determine on or prior to the Effective Date in accordance with the Bankruptcy Code is adequate for the purpose of determining the amount of Cash or number of shares of Reorganized ETS Stock to be deposited in the Disputed Claims Reserve Accounts, and (b) to the extent such Disputed Claim is an unliquidated or contingent Claim, an amount that the Bankruptcy Court shall determine on or prior to the Effective Date in accordance with the Bankruptcy Code is adequate for the purpose of determining the amount of Cash or number of shares of Reorganized ETS Stock to be deposited in the Disputed Claims Reserve Accounts, and in each such case, such amount shall be the maximum allowable amount of such Claim unless the Bankruptcy Court shall order otherwise.

2. *Administrative Expense Claim* means a Claim for payment of administrative expense of a kind specified in section 503(b) of the Bankruptcy Code and referred to in section 507(a)(1) of the Bankruptcy Code, including, without limitation: (a) the actual, necessary costs and expenses incurred after the Petition Date of preserving the Estates and operating the

businesses of the Debtors, including wages, salaries or commissions for services; (b) Professional Fee Claims, including compensation for legal, financial advisory, accounting and other services and reimbursement of expenses awarded or allowed under section 330(a) or 331 of the Bankruptcy Code; and (c) all fees and charges assessed against the Estates under chapter 123 of title 28, United States Code, 28 U.S.C. §§ 1911-1930.

3. *Allowed Administrative Expense Claim* means all or that portion of an Administrative Expense Claim which either: (a) has been allowed by a Final Order as an Administrative Expense Claim; or (b) was incurred by Debtors in the ordinary course of business during the Chapter 11 Cases and is determined to be due, owing, valid and enforceable by Debtors without offset, defense or counterclaim.

4. *Allowed Alternative Claim* means a Payphone Investor Claim in respect of which the Holder thereof has exercised its election to have such Claim allowed in the amount of $1.00 pursuant to Article III.V.4 of the Joint Plan.

5. *Allowed Claim* means that portion of any Claim, other than an Administrative Expense Claim, (a) as to which (i) no proof of Claim has been timely or deemed timely filed in accordance with the Bar Date Order and (ii) the liquidated and noncontingent amount of which has been scheduled by a Debtor pursuant to the Bankruptcy Code as undisputed; or (b) as to which a proof of Claim has been timely filed in a liquidated amount in accordance with the Bar Date Order or any other order of the Bankruptcy Court, provided that: (i) no objection to the allowance of such Claim or motion to expunge such Claim has been interposed before any final date for the filing of such objections or motions as set forth in the Confirmation Order or other Bankruptcy Court order, or (ii) if such objection or motion has been filed and not withdrawn, such objection or motion has been overruled by a Final Order (but only to the extent such objection or motion has been overruled); or (c) as to which a Final Order has been entered allowing such Claim; or (d) that is expressly allowed in a liquidated amount in the Joint Plan.

6. *Articles of Incorporation* means the Articles of Incorporation of Reorganized ETS which shall be substantially in the form set forth in Exhibit 3 to the Joint Plan.

7. *Ballot* means the form(s) of ballot(s) approved by the Bankruptcy Court for use in connection with voting on the Joint Plan.

8. *Bankruptcy Code* means title 11 of the United States Code 11 U.S.C. §§101-1330, as now in effect or hereafter amended.

9. *Bankruptcy Court* means the United States Bankruptcy Court for the District of Delaware and, to the extent it may exercise jurisdiction in the Chapter 11 Cases, the United States District Bankruptcy Court for the District of Delaware, or if either such Bankruptcy Court ceases to exercise jurisdiction over the Chapter 11 Cases, such other Bankruptcy Court that properly exercises jurisdiction over the Chapter 11 Cases.

10. *Bankruptcy Rules* means, collectively, the Federal Rules of Bankruptcy Procedure, as amended, promulgated under 28 U.S.C. § 2015, and the general and local rules of the Bankruptcy Court, as applicable from time to time in the Chapter 11 Cases.

11. *Bar Date* means August 17, 2001, which has been designated by the Bar Date Order as the last date for filing proofs of claim against or Interests in Debtor(s).

12. *Bar Date Order* means the Order Establishing Bar Dates for Filing Proofs of Claim and Approving Form and Manner Thereof, entered by the Bankruptcy Court on June 15, 2001.

13. *Business Day* means any day except a Saturday, Sunday or "legal holiday" (as defined in Bankruptcy Rule 9006(a)).

14. *By-laws* means the By-laws of Reorganized ETS which shall be substantially in the form set forth in Exhibit 4 to the Joint Plan.

15. *Chapter 11 Cases* means the jointly administered bankruptcy cases of ETS Payphones, Inc. and the Debtor Affiliates, case numbers 00-3570 through 00-3572 and 00-3718 through 00-3725.

16. *Cash* means cash and cash equivalents.

17. *Claim* means a claim against one or more of the Debtors, whether asserted or not asserted, as defined in section 101(5) of Bankruptcy Code.

18. *Class* means a category of holders of Claims or Interests as defined in Article III of the Joint Plan.

19. *Compensation Estimate* means (a) a written good faith estimate, to be filed on or before three calendar days before the first date set for the hearing on the confirmation of the Joint Plan of the maximum amount of compensation and reimbursement of expenses to be requested for any period prior to the Confirmation Date, including, without limitation, any Substantial Contribution Claims in the Chapter 11 Cases and for any fees or premiums in addition to normal hourly charges or quoted fees, and (b) a written good faith estimate, to be filed on or before five calendar days before the first date scheduled for the Effective Date of the maximum amount of compensation and reimbursement of expenses to be requested for any period subsequent to the Confirmation Date but prior to the Effective Date, including, without limitation, any Substantial Contribution Claims in the Chapter 11 Cases and for any fees or premiums in addition to normal hourly charges or quoted fees.

20. *Confirmation Date* means the date on which the Bankruptcy Court enters the Confirmation Order on its docket, within the meaning of Bankruptcy Rules 5003 and 9021.

21. *Confirmation Order* means the order of the Bankruptcy Court confirming the Joint Plan pursuant to section 1129 of the Bankruptcy Code.

22. *Creditor* means any Person who holds a Claim against Debtor(s).

23. *Creditors' Committee* means the Official Committee of Unsecured Creditors appointed on September 27, 2001, for the Chapter 11 Cases pursuant to section 1102 of the Bankruptcy Code in Chapter 11 Cases.

24. *Debtor Affiliates* means the debtors, other than ETS whose cases are jointly administered with ETS, including PSA, Inc.; ETS Vending Inc.; Americom, Inc.; City Public Phones, Inc.; ETS Payphones of California, Inc.; ETS Management Services, LLC; MSC National, Inc.; S and R Telecommunications Consultants, Inc.; TSC Payphone Corp.; and Phoenix Telecom of Puerto Rico, Inc.

25. *Debtors* means the eleven debtors and debtors in possession in these Chapter 11 Cases, consisting of ETS and the Debtor Affiliates.

26. *Declaratory Judgment Action* means Adversary Proceeding No. A-01-4711, *PSA, Inc., and ETS Payphones, Inc. v. John T. Woodley, et al.*, filed by Debtors against the Payphone Investors.

27. *Disbursing Agent* means an entity to be designated by Debtors and Creditors' Committee not less than ten (10) days prior to the hearing on confirmation of the Joint Plan, which entity shall be approved by the Bankruptcy Court.

28. *Disclosure Statement* means the disclosure statement filed by Debtors and Creditors' Committee, as it may be amended, modified or supplemented (and all exhibits or schedules annexed thereto or referenced therein), filed with respect to the Joint Plan and approved by the Bankruptcy Court pursuant to section 1125 of the Bankruptcy Code.

29. *Disclosure Statement Summary* means any summary of the Disclosure Statement approved by the Bankruptcy Court.

30. *Disputed Claim* means a Claim against Debtors, as to which an objection (including any proceeding seeking subordination of such Claim) or a motion pursuant to section 502 of the Bankruptcy Code has been timely filed by any party in interest and which objection or motion has not been withdrawn or overruled or denied by a Final Order. To the extent such objection or motion relates to the allowance of any part of a Claim, such Claim shall be a Disputed Claim only to the extent of the objection. Prior to the time that an objection has been or may be timely filed, for the purposes of the Joint Plan, a Claim may be considered a Disputed Claim to the extent that the amount, classification, nature or other basis thereof of the Claim specified in the proof of Claim and or exceeds either the amount, classification, nature or other basis of the Claim scheduled by Debtors.

31. *Disputed [class or category] Claim* means a Disputed Claim in the particular Class or category of Claims identified.

32. *Disputed Claims Reserve Accounts* means the escrow accounts maintained by the Disbursing Agent as described in Article VI of the Joint Plan.

33. *Distributions* means the Cash, shares of Reorganized ETS Stock, or proceeds of the Litigation Trust to be distributed or reserved in accordance with the Joint Plan.

34. *Distribution Date* means (a) with respect to a Claim that is an Allowed Claim as of the Effective Date, a date occurring as soon as practical after the Effective Date, upon which Distributions are to be made by the Disbursing Agent to Holders of Allowed Claims, and that is

no later than thirty (30) days after the Effective Date, and (b) with respect to a Claim that is a Disputed Claim as of the Effective Date or is, not an Allowed Claim otherwise, a date upon which Distributions are to be made by the Disbursing Agent, occurring as soon as practical after the date on which such Claim becomes an Allowed Claim, and that is within forty-five (45) days after the date on which such Claim becomes an Allowed Claim.

35. *Effective Date* means a date selected by Debtors and the Committee that is no more than ten (10) Business Days following the date on which all conditions set forth in Article VIII of Joint Plan have been satisfied or, if capable of being waived, duly and expressly waived pursuant to the Joint Plan.

36. *Estates* means the estates created for Debtors in their Chapter 11 Cases pursuant to section 541 of the Bankruptcy Code, as substantively consolidated for purposes of the Joint Plan.

37. *ETS* means ETS Payphones, Inc., a Georgia corporation, one of the debtors in possession.

38. *Exchange Act* means the Securities and Exchange Act of 1934, as now in effect or hereinafter amended.

39. *Face Amount* means the undisputed liquidated principal amount of a Claim.

40. *Final Order* means an order of the Bankruptcy Court: (a) as to which the time to appeal, petition for certiorari, or move for reargument, rehearing or new trial has expired and as to which no appeal, petition for certiorari, or other proceedings for reargument, rehearing or new trial shall then be pending; (b) as to which any right to appeal, petition for certiorari, reargue, rehear or retry shall have been waived in writing in form and substance satisfactory to Debtors and Creditors' Committee; or (c) in the event that an appeal, writ of certiorari, reargument, rehearing or new trial has been sought, as to which: (i) such order of the Bankruptcy Court shall have been affirmed by the highest Bankruptcy Court to which such order is appealed; (ii) certiorari has been denied as to such order; or (iii) reargument or rehearing or new trial from such order shall have been denied, and the time to take any further appeal, petition for certiorari or move for reargument, rehearing or new trial shall have expired without such action having been taken.

41. *General Unsecured Claim* means any Claim against Debtors that is not an Administrative Expense Claim, a Tax Claim, a Priority Non-Tax Claim, a Secured Claim, a Payphone Investor Claim, an Intercompany Claim, or a Non-Debtor Affiliate Claim. A Claim arising from the rejection of an unexpired lease or executory contract shall constitute a General Unsecured Claim.

42. *General Unsecured Distributions* means the following: (a) on the Distribution Date, the sum of $975,000; (b) on or before January 31, 2003 the sum that is equal to seventeen and one half percent (17½%) of the aggregate amount of unencumbered Cash on deposit in the deposit accounts in the name of Reorganized ETS as of December 31, 2002 to the extent such Cash exceeds the sum of two million dollars ($2,000,000), provided however, that the amount to be distributed pursuant to this clause (b) shall not exceed the sum of one and one-half million

dollars ($1,500,000); (c) on or before January 31, 2004, the sum that is equal to fifteen percent (15%) of the aggregate amount of unencumbered Cash on deposit in the deposit accounts in the name of Reorganized ETS as of December 31, 2003 to the extent such Cash exceeds the sum of two million dollars ($2,000,000), provided, however, that the amount to be distributed pursuant to this clause (c) shall not exceed the sum of one million dollars ($1,000,000); and (d) on or before January 31, 2005, the sum that is equal to fifteen percent (15%) of the aggregate amount of unencumbered Cash on deposit in the deposit accounts in the name of Reorganized ETS as of December 31, 2004, to the extent such Cash exceeds the sum of two million dollars ($2,000,000), provided, however, that the amount to be distributed pursuant to this clause (d) shall not exceed the sum of one million dollars ($1,000,000).

43. *Holder* means a Person who owns, either legally or equitably, a Claim or Interest, including persons who hold legal title as custodians or trustees for the benefit of other Persons (including IRA custodians).

44. *Impaired* means, when used with reference to a Claim or Interest, a Claim or Interest that is impaired within the meaning of section 1124 of the Bankruptcy Code.

45. *Interest* means equity security interest in ETS or the Debtor Affiliates pursuant to section 101(16) of the Bankruptcy Code.

46. *Intercompany Claim* means any Claim held by ETS or a Debtor Affiliate against ETS or any other Debtor Affiliate.

47. *Joint Plan* means the Joint Reorganization Plan submitted by Debtors and the Creditors' Committee and all exhibits and schedules annexed hereto or referenced herein, as it may be amended, supplemented or modified by Debtors and Creditors' Committee from time to time in accordance with the Bankruptcy Code and the Bankruptcy Rules, and the terms and conditions of Article VIII.D of the Joint Plan.

48. *Litigation Trust* means the trust established on the Effective Date pursuant to Article IV.N of the Joint Plan for the purpose of investigating and prosecuting, through litigation or otherwise, all claims and causes of action of Debtors or Creditors' Committee existing as of the Petition Date against (a) Charles Edwards, (b) any insider of Debtors, (c) any Person provided that such claim or cause of action arises under or relates to sections 544, 547, 548, 549 or 550 of the Bankruptcy Code or theories of conversion, breach of fiduciary duty or fraud, (d) any Person provided that such claim or cause of action arises under or relates to Debtors' alleged violation of Federal and State Securities laws or the allegations set forth in the SEC Action, and (e) any Person provided such claim or cause of action arises in connection with or relates to Debtors' sale of payphones (f) any officer, director, agent, affiliate, spouse, insider, initial transferee or subsequent transferee of any of the Persons described in clauses (a) through (e) of this sentence, and any Person acting in concert with or under the direction or control of any of the Persons described in clauses (a) through (e) of this sentence.

49. *Litigation Trust Allocation Formula* means the formula for allocating the Cash to be distributed by the Litigation Trust to Holders of Allowed Class 3 Claims and Allowed Class 4 Claims, which shall be applied as follows:

(a) the amount to be allocated to Class 3 Claims shall be determined by multiplying the aggregate amount of Cash to be distributed by the Litigation Trust by fifteen percent (15%); and

(b) the amount to be allocated to Class 4 Claims shall be determined by multiplying the aggregate amount of Cash to be distributed by the Litigation Trust by eighty-five percent (85%).

50. *Location Owner* means a Person that is an owner, agent, lessee, or manager (and their respective successors in interest) of real property that entered into a binding agreement with Debtors whereby Debtors would operate and manage payphones on such real property.

51. *Nondebtor Affiliates* means all affiliates of ETS as that term is defined in section 101(2) of the Bankruptcy Code of the Debtors that are not debtors in possession in the Chapter 11 Cases including, but not limited to, Twinleaf, Inc. and its subsidiaries including Legends Communications, Inc.

52. *Ordinary Course Professionals* means those professionals retained by Debtors pursuant to the Ordinary Course Professionals Order.

53. *Ordinary Course Professionals Order* means the order authorizing Debtors to retain and pay Ordinary Course Professionals entered by the Bankruptcy Court on November 22, 2000.

54. *Other Secured Claims* means the Secured Claims asserted by Persons other than Triangle Telephone Site Leases LLC and General Motors Acceptance Corporation.

55. *Old Stock* means any stock issued, or subject to issuance, by ETS Payphones, Inc. and authorized and outstanding immediately prior to the Distribution Record Date, and any items convertible into the stock of ETS Payphones, Inc.

56. *Payphone Investor* means a Holder of a Payphone Investor Claim.

57. *Payphone Investor Agreement* means the transactions and agreements between Debtors and Payphone Investors that became the subject of the SEC Action.

58. *Payphone Investor Claim* means a Claim asserted by or on behalf of a Person arising from or relating to (a) a lease or alleged lease of one or more payphones to Debtors pursuant to a written or oral agreement, regardless of whether the payphone equipment or location was specified in such agreement, together with all related agreements, including, without limitation, a bill of sale and a buy back agreement, (b) the payment of money to Debtors directly or indirectly (such as through one or more brokers, agents or intermediaries), with the expectation or understanding that such Person would become an owner of one or more payphones and would lease such payphones to Debtors, (c) the operation or management by Debtors of one or more payphones alleged to be owned by or on behalf of such Person or (d) an investment contract as defined in the Securities Act or Exchange Act other than any contract between Debtors and Charles E. Edwards or Larry Ginsburg.

59. *Payphone Investor Claim Formula* means the formula or method to be used for determining the Allowed Amount of each Payphone Investor Claim, which shall be calculated per Payphone Investor Agreement by adding the aggregate amount of all monthly payments remaining as of the Petition Date under the existing term of the Payphone Investor's Payphone Investor Agreement together with the amount of Debtors' buy-back obligation with respect to the payphones subject to the particular Payphone Investor Agreement. For each Payphone Investor Agreement for which no initial cash investment was made by the Payphone Investor, (a) if the payphones subject to the Payphone Investor Agreement were provided to the Payphone Investor as a commission and, at the time the payphones were provided, Debtors issued an IRS Form 1099 to the Payphone Investor with respect to such payphones, the Payphone Investor Claim Formula shall be forty percent (40%) of the amount reflected as income in such IRS Form 1099 added to the remaining monthly payments as of the Petition Date in the existing term of the particular Payphone Investor Agreement, or (b) if the payphone subject to the Payphone Investor Agreement was not provided to the Payphone Investor as a commission or if an IRS Form 1099 was not issued by Debtors to the Payphone Investor at the time such payphone was provided to the Payphone Investor, the Payphone Investor Claim Formula shall be the Payphone Investor's Claim, as asserted by the Payphone Investor, multiplied by zero so that the resulting Allowed Payphone Investor Claim is zero.

60. *Person* shall have the meaning set forth in section 101(41) of the Bankruptcy Code.

61. *Petition Date* means September 11, 2000 and September 21, 2000.

62. *Phoenix Litigation* means the action brought by William G. Hays, Jr., as receiver for Phoenix Telecom, L.L.C., that was the subject of Hays' Motion for Relief from the Automatic Stay filed in the Chapter 11 Cases dated October 20, 2000.

63. *Plan Documents* means the documents to be executed, delivered, assumed and/or performed in conjunction with the consummation of the Joint Plan on the Effective Date including, but not limited to the agreement in respect of the Litigation Trust, the By-Laws, the Articles of Incorporation, and Management Employment Agreements.

64. *Plan Supplement* means any supplemental appendix to the Joint Plan that is filed with the Bankruptcy Court no later than ten days before the hearing on confirmation of the Joint Plan, which may contain the draft form of the Plan Documents.

65. *Priority Non-Tax Claim* means a Claim for an amount entitled to priority under section 507(a) of the Bankruptcy Code, other than an Administrative Expense Claim or a Tax Claim.

66. *Professional Fee Claim* means a Claim for fees and expenses of professionals pursuant to sections 327, 328, 330, 331, 503(b) (other than Substantial Contribution Claims) or 1103 of the Bankruptcy Code.

67. *Professional Fee Order* means the administrative order pursuant to sections 105(a) and 331 of the Bankruptcy Code, Establishing Procedures for Interim Compensation and

Reimbursement of Professionals, entered by the Bankruptcy Court and dated December 12, 2000.

68. *Record Date* means the date established by the Bankruptcy Court as the record date for determining the identity of Holders of Claims for all purposes under the Joint Plan, which shall be no earlier than July 27, 2001 and no later than the Effective Date.

69. *Reorganized ETS* means Debtors on and after the Effective Date.

70. *Reorganized ETS Stock* means six million shares of new common stock of Reorganized ETS, par value $0.0001 per share, five million shares of which will be issued to Holders of Allowed Payphone Investor Claims.

71. *Representatives* means as to the referenced Person, such Person's present and former officers, directors, shareholders, trustees, affiliates, partners and partnerships, members, agents, employees, representatives, financial advisors, professionals, accountants, attorneys, commercial bankers, lenders, insurers, heirs, executors, estates, administrators, successors or assigns of any of the foregoing, in each case solely in their capacity as such.

72. *Schedules* means, collectively: (a) the schedules of assets and liabilities and the statement of financial affairs filed by Debtors in the Chapter 11 Cases, pursuant to section 521 of the Bankruptcy Code and the Bankruptcy Rules as amended; and (b) the schedules of unliquidated, disputed or contingent Claims, as required by any local rule of the Bankruptcy Court, as amended, as such requirements may be modified by any Order of the Bankruptcy Court.

73. *SEC Action* means Civil Action No. 1:00-CV-2432-JTC, styled *Securities and Exchange Commission v. ETS Payphones, Inc. and Charles E. Edwards* pending in the United States District Court for the Northern District of Georgia.

74. *SEC* Claim means the Claim asserted by the United States and Securities Exchange Commission.

75. *Secured Claim* means a Claim that is secured by a lien on property in which any or all of Debtors have an interest or that is subject to setoff under section 553 of the Bankruptcy Code, to the extent of the lesser of (a) the value of the Claim Holder's interest in such property, or (b) the value of Debtors' interest in such property, to the extent of the amount subject to setoff, as applicable, as determined pursuant to section 506(a) of the Bankruptcy Code.

76. *Securities Act* means the Securities Act of 1933 as now in effect or hereafter amended.

77. *Subordinated Claims* means any Claim against or Interest in Debtors subject to subordination rights, either contractual, legal or equitable pursuant to section 510 of the Bankruptcy Code.

78. *Substantial Contribution Claim* means any Claim for reimbursement asserted pursuant to section 503(b)(3)(D) of the Bankruptcy Code.

79. *Tax Claim* means a Claim that is entitled to priority under section 507(a)(8) of the Bankruptcy Code.

80. *Unclaimed Distribution Reserve* means the segregated account maintained by Disbursing Agent containing any Distribution returned to Disbursing Agent as undeliverable or unclaimed.

81. *Unimpaired* means, with respect to a Claim or Interest, a Claim or Interest that is not impaired within the meaning of section 1124 of the Bankruptcy Code.

82. *United States* means the United States of America and all agencies thereof.

83. *Voting Deadline* means 5:00 p.m. Pacific Prevailing Time on August 24, 2001, the date fixed by the Bankruptcy Court after which Ballots with respect to the Joint Plan may no longer be accepted by Debtors or Claims Agent.

B. **Rules of Interpretation and Computation of Time and Governing Law.**

1. **Rules of Interpretation.** For purposes of this Joint Plan (a) whenever from the context it is appropriate, each term, whether stated in the singular or the plural, shall include both the singular and the plural; (b) any reference in this Joint Plan to a contract, instrument, release, indenture or other agreement or document being in a particular form or on particular terms and conditions means that such document shall be substantially and materially in such form or substantially and materially on such terms and conditions. (c) any reference in this Joint Plan to an existing document or exhibit to this Joint Plan or Disclosure Statement filed or to be filed means such document, schedule or exhibit, as it may have been or may be amended, modified or supplemented; (d) if this Joint Plan's description of the terms of a Plan Document, schedule or exhibit to this Joint Plan, or Disclosure Statement is inconsistent with the terms of such Plan Document or exhibit, the terms of the Plan Document, schedule or exhibit shall control; (e) to the extent that this Joint Plan's description of a Person's obligations under a Plan Document are inconsistent with the terms of the Plan Document, the Plan Document shall control; (f) unless otherwise specified, all references in this Joint Plan to articles, sections, clauses, schedules and exhibits are references to articles, sections, clauses, schedules and exhibits of or to this Joint Plan unless otherwise specified; (g) the words "herein" and "hereto" refer to this Joint Plan in its entirety rather than to a particular portion of this Joint Plan; (h) captions and headings to articles and sections are inserted for convenience of reference only and are not intended to be a part of or to affect the interpretation of this Joint Plan; (i) the rules of construction set forth in section 102 of the Bankruptcy Code shall apply to the extent such rules are not inconsistent with any other provision in this Article I.B. Payments and acts required to be made or performed pursuant to the Plan Documents shall be made or performed in accordance with the terms of the applicable Plan Document.

2. **Computation of Time.** In computing any period of time prescribed or allowed by this Joint Plan, the provisions of Bankruptcy Rule 9006(a) shall apply.

ARTICLE II

CLASSIFICATION OF CLAIMS AGAINST AND INTERESTS IN THE DEBTORS

The classification of the Claims and Interests listed below shall be for all purposes, including voting, confirmation and Distributions pursuant to this Joint Plan. A Claim or Interest is in a particular class only to the extent that the Claim or Interest qualifies within the description of that Class and is classified in other Classes to the extent that any remainder of the Claim or Interest qualifies within the description of such other classes. A Claim or Interest that is not an Allowed Claim or Interest is not in any class and does not receive any payments, Distributions or rights under this Joint Plan. Debtors and Creditors' Committee reserve the right to have any Claim or Interest reclassified as appropriate and to the extent permitted by the Bankruptcy Court. In accordance with section 1123(a)(1) of the Bankruptcy Code, Administrative Expense Claims and Tax Claims are not classified in the Joint Plan.

A. **Class 1 - Priority Non-Tax Claims.** Class 1 consists of all Allowed Priority Non-Tax Claims.

B. **Class 2 - Secured Claims.** Class 2 consists of all Allowed Secured Claims. Class 2(a) consists of the Allowed Secured Claim of General Motors Acceptance Corporation. Class 2(b) consists of the Allowed Secured Claim of Triangle Telephone Site Leases, LLC. Class 2(c) consists of all Allowed Other Secured Claims.

C. **Class 3 - General Unsecured Claims.** Class 3 consists of all Allowed General Unsecured Claims. Class 3(a) consists of all Allowed General Unsecured Claims other than the SEC Claim. Class 3(b) consists of the SEC Claim.

D. **Class 4 - Payphone Investor Claims.** Class 4 consists of all Allowed Payphone Investor Claims.

E. **Class 5 - Subordinated Claims.** Class 5 consists of all Allowed Subordinated Claims.

F. **Class 6 - Intercompany Claims.** Class 6 consists of all Intercompany Claims.

G. **Class 7 - Non-Debtor Affiliate Claims.** Class 7 consists of claims of any Nondebtor Affiliate against any Debtor.

H. **Class 8 - Interests in ETS.** Class 8 consists of all Old Stock.

ARTICLE III

TREATMENT OF CLAIMS AND INTERESTS

A. Unclassified Claims

1. Administrative Expense Claims

Each Holder of an Allowed Administrative Expense Claim shall receive, in full satisfaction, settlement, release, and discharge of and in exchange for such Allowed Administrative Expense Claim: (i) Cash equal to the unpaid portion of such Allowed Administrative Expense Claim or (ii) such other treatment as to which the Debtors and such Holder have agreed in writing; *provided, however,* that Allowed Administrative Expense Claims with respect to liabilities incurred by a Debtor in the ordinary course of business during the Chapter 11 Cases shall be paid in the ordinary course of business in accordance with the terms and conditions of any agreements relating thereto.

All interim and final payments to professionals for compensation and reimbursement of expenses and all payments to reimburse members of the Creditors' Committee for expenses incurred in performing their duties shall be made in accordance with the procedures established by the Professional Fee Order.

2. Tax Claims

Each Holder of an Allowed Tax Claim shall be entitled to receive, in full satisfaction, settlement, release, and discharge of and in exchange for such Allowed Tax Claim: (a) deferred Cash payments payable in twenty-four (24) equal quarterly installments commencing on the later of the first Business Day after the date of assessment and the Effective Date in an aggregate principal amount equal to the amount of such Allowed Tax Claim, plus interest on the unpaid portion thereof at an interest rate to be fixed or approved by the Bankruptcy Court at the Confirmation Hearing, from the Effective Date through the date of payment thereof; or (b) such other treatment as to which Debtors and such Holder shall have agreed upon in writing; or (c) if deferred Cash payments are made to a Holder of an Allowed Tax Claim, payments of principal shall be made in quarterly installments, each such installment amount being equal to four percent (4%) of such Allowed Tax Claim plus accrued and unpaid interest. Any installments remaining unpaid on the date that is six years after the date of assessment of the tax that is the basis for the Allowed Tax Claim shall be paid on the first Business Day following such date, or as soon as practicable thereafter, together with any accrued and unpaid interest to the date of payment provided, however, that Reorganized ETS will have the right to pay any Allowed Tax Claim, or any remaining balance of any Allowed Tax Claim, in full at any time on or after the Effective Date without premium or penalty; and *provided, further,* that any Claim or demand for payment of a penalty (other than a penalty or the type specified in section 507(a)(8)(G) of the Bankruptcy Code) shall be disallowed pursuant to the Joint Plan, and the Holder of an Allowed Tax claim shall not assess or attempt to collect such penalty from Debtors, the Estates, Reorganized ETS, or any of them.

B. Classified Claims

1. Class 1: Priority Non-Tax Claims

Each Holder of an Allowed Priority Non-Tax Claim shall receive, in full satisfaction, settlement, release, and discharge of and in exchange for such Allowed Priority Non-Tax Claim (i) Cash equal to the unpaid portion of such Allowed Class 1 Priority Non-Tax Claim or (ii) such other treatment as to which the Debtors and such Holder shall have agreed upon in writing. Class 1 is unimpaired and is deemed to have accepted the Joint Plan.

2. Class 2: Secured Claims

Each Holder of an Allowed Secured Claim shall receive, at Debtor's option, (i) Cash equal to the Allowed Secured Claims; (ii) the sale or disposition proceeds of the property securing any Allowed Secured Claim to the extent of the value of the Holder's interest in such property; (iii) the property surrendered by the Debtors; (iv) such other treatment pursuant to section 1124(1) of the Bankruptcy Code; or (v) its contractual rights reinstated and rendered unimpaired in accordance with section 1124(2) of the Bankruptcy Code, in which event the Debtors shall cure any defaults, reinstate the maturity of such Allowed Secured Claim, and make the contractual payments pursuant to the parties' agreement. Classes 2(a), 2(b) and 2(c) are unimpaired and are deemed to have accepted the Joint Plan.

To the extent, if any, that the value of the collateral securing a Class 2 Secured Claims is less than the total amount of such Claims, the difference shall be treated as a Class 3 General Unsecured Claim. Debtors specifically reserve all rights to challenge the validity, nature, and perfection and enforceability of, and to avoid pursuant to the provisions of the Bankruptcy Code and other applicable law, any asserted liens.

3. Class 3: General Unsecured Claims

Each Holder of an Allowed Class 3(a) and 3(b) Claim shall receive in full satisfaction, settlement, release and discharge of and in exchange for such Claim (a) its pro rata share of the General Unsecured Distributions, and (b) its pro rata share of the Litigation Trust pursuant to the Litigation Trust Allocation Formula applicable to Class 3.

Class 3 is impaired under the Joint Plan and is entitled to vote to accept or reject the Joint Plan.

4. Class 4: Payphone Investor Claims

The Allowed Amount of each Payphone Investor Claim shall be determined by the Payphone Investor Claim Formula.

Each holder of an Allowed Class 4 Claim shall receive in full satisfaction, settlement, release and discharge of and in exchange for such Claim (a) its pro rata share of the Reorganized ETS Stock and (b) its pro rata share of funds allocated to Class 4 in the Litigation Trust pursuant to the Litigation Trust Allocation Formula applicable to Class 4. Alternatively, each Holder of a Claim that would otherwise be an Allowed Class 4 Claim, for tax or other reasons, may elect to

reduce its Class 4 Claim to $1.00 and have such Claim treated as an Allowed Alternative Claim by filing notice of such election on or before the Distribution Date.

Class 4 is impaired under the Joint Plan and is entitled to vote to accept or reject the Joint Plan.

5. Class 5: Subordinated Claims

Holders of Allowed Class 5 Subordinated Claims in full satisfaction, settlement, release and discharge of and in exchange for such Claim shall not receive any property or interest in property on account of its Allowed Class 5 Claim. Class 5 is deemed to have rejected the Joint Plan.

6. Class 6: Intercompany Claims

On the Effective Date, all Class 6 Intercompany Claims shall be extinguished through the substantive consolidation of the Debtors, and each Holder thereof shall not be entitled to and shall not receive or retain any property or interest in property on account of its Intercompany Claim. Class 6 is deemed to have rejected the Joint Plan.

7. Class 7: Non-Debtor Affiliate Claims

Each Holder of a Class 7 Claim in full satisfaction, settlement, release and discharge of and in exchange for such Claim shall not receive or reclaim any property or interest in property on account of its Class 7 Claim. Class 7 is deemed to have rejected the Joint Plan.

8. Class 8: Interests

On the Effective Date, the Class 8 Interests in Debtors shall be canceled, deemed extinguished, and each Holder of an Interest shall not be entitled to, and shall not, receive or retain any property or interest in property on account of such Class 8 Interest. Any certificate representing any Interest in ETS shall be of no force and effect. Class 8 is deemed to have rejected the Joint Plan.

ARTICLE IV

MEANS FOR IMPLEMENTATION OF THE JOINT PLAN

A. Resolution of the Declaratory Judgment Action

Debtors must obtain a Final Order that Debtors are owners of all payphones and related assets which would otherwise be subject to the Payphone Investor Agreements in order to raise sufficient funds to reorganize Debtors and make the required payments under the Joint Plan. Debtors propose to settle the Declaratory Judgment Action by making the Payphone Investors the shareholders of Reorganized ETS. The occurrence of Effective Date is conditioned upon a successful resolution of the Declaratory Judgment Action, including pursuant to the terms outlined for treatment of Payphone Investor Claims set forth herein.

Debtors and Committee propose to settle the Declaratory Judgment Action by providing that each Payphone Investor Claim be calculated by adding the aggregate amount of all monthly payments remaining as of the Petition Date under the existing term of the Payphone Investor's Payphone Investor Agreement together with the amount of Debtors' buy-back obligation with respect to the payphones subject to the particular Payphone Investor Agreement. For each Payphone Investor Agreement for which no initial cash investment was made by the Payphone Investor, the Payphone Investor Claim shall be (a) if payphones subject to the Payphone Investor Agreement were provided to the Payphone Investor as a commission and, at the time the payphones were provided Debtors, issued an IRS Form 1099 to the Payphone Investor with respect to such payphones, the allowed Amount of the Payphone Investor Claim shall be calculated by adding forty percent (40%) of the amount reflected as income in such IRS Form 1099 and the remaining monthly payments as of the Petition Date in the existing term under the particular Payphone Investor Agreement, or (b) if the payphone subject to the Payphone Investor Agreement was not provided to the Payphone Investor as a commission or if an IRS Form 1099 was not issued by Debtors to the Payphone Investor at the time such payphone was provided to the Payphone Investor, the resulting Allowed Amount of the Payphone Investor Claim shall be zero.

B. Settlement of SEC Action and Phoenix Litigation

1. SEC Action. Debtors shall seek to compromise and settle the claims asserted against Debtors in the SEC Action in a manner which, *inter alia*, would not require any payment with respect to the SEC Claim and would release Debtors from the claims and causes of action in the SEC Action. Any settlement shall require a Final Order of the Bankruptcy Court and approval from the court in which the SEC Action is pending.

2. Phoenix Litigation. Debtors shall seek to compromise and settle all claims between them, on one hand, and William G. Hays, Jr., as receiver for Phoenix Telecom, L.L.C., on the other, in a manner which is fair, equitable, and in the best interest of the Debtors' estates. Such settlement may include, *inter alia*, the turnover to the Debtors of certain funds held by Mr. Hays as receiver, and the Debtors' agreement that certain investors in Phoenix Telecom L.L.C. shall be treated as Payphone Investors under this Joint Plan. Any settlement shall require Bankruptcy Court approval and approval from the court that appointed Mr. Hays as the receiver.

C. Administrative Claim Bar Date

1. Pre-Confirmation Date Claims and Expenses. All applications for payment of administrative expenses incurred on or before the Confirmation Date under section 507(a)(1) or 507(b) of the Bankruptcy Code (except for Claims incurred in the ordinary course of business, Claims under 28 U.S.C. § 1930, and Claims of court-approved professionals under sections 327, 328, 330, 331, 503(b) or 1103 of the Bankruptcy Code) shall be filed no later than forty-five (45) days after the Confirmation Date.

2. Professional Fee Claims. Professionals or other Persons asserting an Administrative Claim (other than Substantial Contribution Claims) for services rendered before the Effective Date must file and serve on Reorganized ETS and such other entities designated by the Bankruptcy Rules, the Confirmation Order, the Professional Fee Order, or other order of the Bankruptcy Court an application for final allowance of such Claim no later than sixty (60) days

after the Effective Date; provided, however, that any professional who may receive compensation or reimbursement of expenses as an Ordinary Course Professional may continue to receive such compensation and reimbursement for expenses for services rendered before the Effective Date, without further Bankruptcy Court review or approval, pursuant to the Ordinary Course Professionals Order. Objections to any Professional Fee Claim must be filed and served on Reorganized ETS and the requesting party by the later of (a) ninety (90) days after the Effective Date, and (b) thirty (30) days after the filing of the applicable request for payment of the Professional Fee Claim. To the extent necessary, the Confirmation Order shall amend and supersede any previously entered order of the Bankruptcy Court, including the Professional Fee Order, regarding the payment of Professional Fee Claims.

3. **Substantial Contribution Claims**. No later than forty-five days after the Confirmation Date, each holder of a Substantial Contribution Claim will: (a) file a motion seeking approval of its Substantial Contribution Claim; and (b) serve such motion on Reorganized ETS and the United States Trustee. Any Holder of a Substantial Contribution Claim that does not file such a motion by such date will be forever barred from asserting such Substantial Contribution Claim against the Debtors, Reorganized ETS or their respective property, and such Substantial Contribution Claims shall be deemed discharged as of the Effective Date. The Bankruptcy Court will approve such fees and expenses requested in the motion to the extent that such amounts are reasonable and appropriate pursuant to section 503(b) of the Bankruptcy Code.

4. **Ordinary Course Claims**. Holders of Administrative Claims for liabilities incurred by a Debtor in the ordinary course of business after the Petition Date shall not be required to file or serve any request for payment of such Administrative Claims as required in Article IV.C of the Joint Plan.

5. **Effect of Failure to Timely file Claims, Requests for Payment or Objections**. Any request for payment of an Administrative Claim or Substantial Contribution Claim that is not filed by the deadline set forth in above shall be barred. Under no circumstances shall the applicable deadlines set forth above be extended by order of the Bankruptcy Court or otherwise. Any Holder of an Administrative Claim or Substantial Contribution Claim who is required to file a Claim or request for payment of such Claims or expenses and who does not timely file such Claims or expenses is enjoined from proceeding against Debtors, Reorganized ETS, or the Litigation Trust or any property of Debtors, Reorganized ETS, or the Litigation Trust and from receiving any distributions under the Joint Plan. Objections to Administrative or Professional Fee Claims must be filed and served on the requesting party by the later of (a) ninety (90) days after the Effective Date, and (b) thirty (30) days after the filing of the request for payment of Administrative Claim or Substantial Contribution Claim. Objections not filed within this time shall be deemed waived.

D. Compensation Estimates

Any Person retained or requesting compensation or expense reimbursement pursuant to sections 326, 327, 328, 330, 503(b)(2) through (6) or 1103 of the Bankruptcy Code shall file a Compensation Estimate (a) on or before three calendar days before the first date set for the hearing on the confirmation of the Joint Plan and (b) on or before five calendar days before the first date scheduled for the Effective Date.

E. Payment of Administrative Claims

Allowed Administrative Claims that are payable in Cash on the Effective Date shall be paid by Disbursing Agent on the Distribution Date.

F. Reserve for and Payment of Professional Fees

On the Effective Date, Disbursing Agent shall reserve funds in the aggregate amount of all Compensation Estimates. Disbursing Agent shall pay Professional Fee Claims on the date such claims become Allowed Claims unless otherwise agreed to by Disbursing Agent and the Holder of such Professional Fee Claim.

Following the Effective Date, Disbursing Agent shall pay all professional fees when and as such professional fees become due and payable.

G. The Effective Date

On the Effective Date, Debtors shall be substantively consolidated and shall be merged with and into Reorganized ETS. Immediately prior to the Effective Date, Debtors shall transfer to the Disbursing Agent all Cash necessary for the Disbursing Agent to make Distributions and establish reserves by this Joint Plan. Immediately after the Effective Date, Reorganized ETS shall issue to the Disbursing Agent all shares of Reorganized ETS Stock required to be distributed to or reserved for Holders of Class 4 Claims.

On the Effective Date, all Claims in Class 5, Class 6 and Class 7 shall be extinguished and discharged.

On the Effective Date, Class 8 Interests in ETS shall be canceled and extinguished, including, without limitation, the Old Stock of ETS.

H. The Distribution Date

On the Distribution Date, the Disbursing Agent shall make Distributions to Holders of Allowed Administrative Claims, Allowed Tax Claims, Allowed Priority Non-Tax Claims and Allowed Secured Claims pursuant to the terms of the Joint Plan.

On the Distribution Date, the Disbursing Agent shall make Distributions to (a) Holders of Allowed Class 3(a) Claims, the initial payment of the General Unsecured Distribution and the pro rata portion of the Litigation Trust allocated to Class 3 Claims pursuant to the Litigation Trust Allocation Formula and (b) Holders of Allowed Class 4 Claims, the pro rata portion of the five million shares of Reorganized ETS Stock and the pro rata portion of the Litigation Trust allocated to Class 4 pursuant to the Litigation Trust Allocation Formula pursuant to the terms of the Joint Plan.

I. Substantive Consolidation and Merger of Corporate Entities

On the Confirmation Date the Debtors' Estates shall be substantially consolidated. Prior to the offer on or before the Effective Date Reorganized ETS will incorporate in Delaware and

ETS Payphones, Inc.; PSA, Inc.; ETS Vending, Inc.; Americom, Inc.; City Public Phones, Inc.; ETS Payphones of California, Inc.; ETS Management Services, LLC; MSC National, Inc.; S and R Telecommunications Consultants, Inc.; TSC Payphone Corp.; and Phoenix Telecom of Puerto Rico, Inc. will be substantively consolidated and immediately merged with and into Reorganized ETS.

Except as otherwise provided by the Joint Plan, upon the occurrence of any such merger, all assets of the merged entities, including, but not limited to, all payphones, automatic number identifiers, permits, certificates, franchises and operating rights shall be transferred to and become the assets of Reorganized ETS, and all liabilities of the merged entities, except to the extent discharged, released, extinguished or as otherwise provided by the Joint Plan and the Confirmation Order, shall be assumed by and shall become the liabilities of the surviving corporation.

The foregoing (a) shall be solely for the purposes of determining the right to Distributions under the Joint Plan; (b) shall not affect either the rights of any Holder of a Secured Claim with respect to the Collateral securing its Claim, or the terms and implementation of any settlement, and the rights and obligations of the parties thereto, entered into in connection with the confirmation of the Joint Plan; and (c) shall not, and shall not be deemed to, prejudice the claims, the proceeds of which are payable to the Litigation Trust, or Debtors or Reorganized ETS, which will survive entry of the Substantive Consolidation Order for the benefit of Debtors, their Estates, and Reorganized ETS as if there had been no substantive consolidation of Debtors and their Estates.

J. Continued Existence of Reorganized ETS

1. Merger of ETS and Debtor Affiliates

On the Effective Date, the following shall be deemed to have occurred and be effective, if applicable, and shall be authorized and approved in all respects, without any requirement of further action by the stockholders or directors of Debtors or Reorganized ETS, and with like effect as if such actions had been taken by unanimous action of the stockholders and directors of Debtors of Reorganized ETS, as applicable (a) ETS's articles of organization in effect under the laws of the State of Georgia prior to the Confirmation Date shall be amended to provide for merger into and with Reorganized ETS along with all other Debtor Affiliates, authorize the issuance of the shares of Reorganized ETS Stock, prohibit the issuance of non-voting stock, provide for no less than three or more than five directors and to name the initial Board of Directors of the Reorganized ETS; and (b) the distribution of Cash and Reorganized ETS Stock by the Disbursing Agent in accordance with the Joint Plan and Confirmation Order; and (c) the implementation of the other matters provided for under the Joint Plan or any other corporate action necessary for or required by the Joint Plan. A copy of the Articles of Incorporation of Reorganized ETS Inc. is attached as Exhibit 3.

Reorganized ETS shall continue to exist to carry on the business of Debtors as Reorganized ETS, a Delaware corporation. Reorganized ETS shall be registered as a foreign corporation doing business in each state where it is expected to operate.

2. By-laws

The by-laws of Reorganized ETS shall be substantially in the form of the by-laws attached hereto as Exhibit 4.

K. Appointment of Disbursing Agent

Under the Joint Plan, Reorganized ETS, or such other entity as may be designated by Debtors and Creditors' Committee, shall serve as Disbursing Agent. All distributions under the Joint Plan shall be made by such designated entity in its capacity as Disbursing Agent. The fees and expenses of the Disbursing Agent, if any, shall be paid and satisfied by Reorganized ETS.

L. Issuance and Delivery of Reorganized ETS Stock

As of the Effective Date, Reorganized ETS shall be authorized to issue up to six million shares of the Reorganized ETS Stock without further act or action under applicable law, regulation, order, or rule. Reorganized ETS shall issue five million of the initial shares of Reorganized ETS Stock to the Disbursing Agent for distribution in accordance with the provisions of the Joint Plan.

All holders of Reorganized ETS Stock shall be entitled to receive dividends, if any, when and as declared by the Board of Directors of Reorganized ETS, provided that Reorganized ETS has funds legally available for distribution and is not otherwise contractually restricted from declaration of any payment therefor. In the event of dissolution, liquidation or winding up of Reorganized ETS, the holders of Reorganized ETS Stock shall be entitled to receive all assets of Reorganized ETS available under law for common stockholders. With respect to voting rights, each share of Reorganized ETS Stock shall entitle the holder thereof to one vote, to be cast in person or by proxy for each share owned. The holders of the Reorganized ETS Stock shall have the right to elect directors to the Board of Directors consistent with the Articles of Incorporation and By-Laws of Reorganized ETS. Reorganized ETS Stock shall not carry with it any preemptive or preferential rights to purchase or subscribe for any additional shares of capital stock issued in the future by Reorganized ETS, whether of a presently existing class or series of stock of one or more that may later be authorized by Reorganized ETS.

Any issuance of Reorganized ETS Stock shall occur in connection with the consummation of the Joint Plan, and shall be exempt from the registration requirements of the Securities Act pursuant to section 1145 of the Bankruptcy Code.

M. Directors and Officers

1. Current Directors of the Debtors

On the Effective Date, the term of the current directors of each of the Debtors shall expire.

2. Board of Directors of Reorganized ETS

The board of directors of Reorganized ETS shall consist of up to five members, which shall include Mr. Longobardo as Chairman, Mr. Michael Buck, Mr. Michael Scott and two additional directors to be named by Creditors' Committee prior to the Effective Date. Except as otherwise provided in the Joint Plan, the Board of Directors of Reorganized ETS shall appoint the officers and other managers, and shall have the responsibility for the management, control, and operation of Reorganized ETS on and after the Effective Date consistent with the Articles of Incorporation and By-Laws of Reorganized ETS.

N. The Litigation Trust

A Litigation Trust shall be created on the Effective Date for the benefit of Holders of Allowed Class 3 General Unsecured Claims and Allowed Class 4 Payphone Investor Claims. The Litigation Trust shall be administered by a trustee selected by the Creditors' Committee on or before the tenth day before the Confirmation Date and the trust agreement governing the Litigation Trust shall be filed as part of the Plan Supplement. The Litigation Trust Agreement shall provide, among other things, (i) for the trustee to make distributions as and when funds are available and in the trustee's sole discretion; (ii) that the life of the Litigation Trust shall be the later of the conclusion of the prosecution of Debtors' and Creditors' Committee's claims and causes of action and three years (subject to extension upon approval of the Bankruptcy Court); (iii) that the trustee shall have the power to waive the attorney client privilege on behalf of Debtors and Creditors' Committee; (iv) the trustee's fees and expenses may be satisfied from the proceeds of the Litigation Trust, payment by Reorganized ETS or otherwise; (v) the trustee shall be considered a "party in interest" with the ability to request an examination pursuant to 2004 of the Federal Rules of Bankruptcy Procedure; (v) the trustee shall be entitled to employ counsel or other professionals; (vi) the trustee shall make available to any Holder of a Claim or any other party in interest in the Chapter 11 Cases a yearly accounting of the Litigation Trust; and (vii) shall be entitled to invest funds of the Litigation Trust in a manner consistent with the investment and deposit guidelines of section 345 of the Bankruptcy Code. The Litigation Trust shall be funded with property and other proceeds of all claims and causes of action of Debtors or Creditors' Committee existing as of the Petition Date against (i) Charles Edwards, (ii) any insider of Debtors, (iii) any Person provided that such claim or cause of action arises under or relates to sections 544, 547, 548, 549 or 550 of the Bankruptcy Code or theories of conversion, breach of fiduciary duty or fraud, (iv) any Person provided that such claim or cause of action arises under or relates to Debtors' alleged violation of Federal and State Securities laws or the allegations set forth in the SEC Action, and (v) any Person provided such claim or cause of action arises in connection with or relates to Debtors' sale of payphones (vi) any officer, director, agent, affiliate, spouse, insider, initial transferee or subsequent transferee of any of the Persons described in clauses (i) through (v) of this sentence, and any person acting in concert with or under the direction or control of any of the Persons described in clauses (i) through (v) of this sentence. Notwithstanding the foregoing, proceeds realized from potential claims and causes of action of Debtors arising after the Petition Date or related to prepetition breeches of contract, Debtors' interest in NYLT, Debtors' investment in Mexico, Debtors' interest in the EUCL litigation and similar litigation shall not become part of the Litigation Trust but shall remain property of Debtors or Reorganized ETS.

O. Employment Agreements

On the Effective Date, Employment Agreements with Guy A. Longobardo and Michael H. McClellan in forms substantially identical to those in Exhibit 5 shall become effective.

P. Revesting of Assets

On the Effective Date, the property of each of the Estates, together with any property of a Debtor that is not property of its Estate and that is not specifically disposed of pursuant to the Joint Plan, shall revest in and/or otherwise become property or asset of Reorganized ETS without the need for any further Bankruptcy Court order or act by Debtors or Reorganized ETS. Thereafter, Reorganized ETS may operate its business and may use, acquire, and dispose of property free of any restrictions of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, and the Bankruptcy Court. As of the Effective Date, all property of Debtors shall be free and clear of all claims and interests, except as specifically provided in the Joint Plan or the Confirmation Order. All licenses, franchises, certificates, automatic number identifier operating permits and other licenses owned by Debtors shall become property of and be transferred to Reorganized ETS without further order of the Bankruptcy Court.

Q. Effectuating Documents; Further Transactions

Debtors and Reorganized ETS shall be authorized to execute, deliver, file, or record such contracts, instruments, releases, and other agreements or documents, and take such actions as may be necessary or appropriate to implement, effectuate and further evidence the terms, and conditions of the Joint Plan. Although not required, Reorganized ETS may elect to file documents of transfer or such other name change information it deems necessary, in its sole discretion, to reflect the revesting of the assets of Debtors in Reorganized ETS.

R. Cancellation of Securities and Agreements

On the Effective Date, except as otherwise provided for in the Joint Plan: (i) any existing Interests and securities, to the extent not already canceled, shall be canceled; and (ii) the obligations of Debtors under such existing securities and under Debtors' certificate of incorporation, any agreements or certificates of designations governing such existing securities will be discharged. On the Effective Date, all Payphone Investor Agreements shall be canceled.

S. Exemption From Certain Transfer Taxes

Pursuant to section 1146(c) of the Bankruptcy Code, any transfers: (i) for any of Debtors to Reorganized ETS or any other Person or entity pursuant to the Joint Plan; or (ii) from Reorganized ETS to any other Person or entity pursuant to the Joint Plan shall not be subject to any document recording tax, stamp tax, conveyance fee, intangibles or similar tax, mortgage tax, stamp act, real estate transfer tax, mortgage recording tax, or other similar tax or governmental assessment, and all appropriate state or local governmental officials or agents shall forego the collection of any such tax or governmental assessment and shall accept for filing and recordation any of the foregoing instruments or other documents without the payment of any such tax or governmental assessment.

T. Settlement Authority

Subject to Bankruptcy Court approval and pursuant to Bankruptcy Rule 9019, following appropriate notice and opportunity for a hearing, Debtors and the Committee expressly reserve the right to compromise and settle Claims against them and claims that they may have against other Persons or entities up to and including the Effective Date. After the Effective Date, the trustee of the Litigation Trust shall have the authority, without court approval, to settle and compromise claims and causes of action the proceeds of which are payable to the Litigation Trust. Reorganized ETS shall have the authority, without court approval, to settle and compromise all other claims and causes of action. Debtors and the Committee reserve the right to modify the Joint Plan to the extent, and consistent with a settlement as it is or is not approved by the Bankruptcy Court, in whole or in part.

U. Payment of Statutory Fees

All fees payable by Debtors under 28 U.S.C. § 1930, as determined by the Bankruptcy Court at the Confirmation Hearing pursuant to section 1128 of the Bankruptcy Code, shall be paid on or before the Distribution Date. All fees payable after the Effective Date by Debtors pursuant to 28 U.S.C. §1930 shall be paid by the Disbursing Agent until the closing of the Chapter 11 Cases pursuant to section 350(a) of the Bankruptcy Code.

V. Severability of Plan Provisions

If, before the Confirmation Date, the Bankruptcy Court holds that any provision of the Joint Plan is invalid, void, or unenforceable: (i) Debtors and Creditors' Committee, at their option, may amend or modify the Joint Plan to correct the defect, by amending or deleting the offending provision or otherwise, or may withdraw the Joint Plan, or (ii) the Bankruptcy Court, at the request of Debtors and the Creditors' Committee, shall have the power to alter and interpret such term or provision held to be invalid, void, and unenforceable to the maximum extent practicable, consistent with the original purpose of the term or provision held to be invalid, void, or unenforceable, and such term or provision shall then be applicable as so altered or interpreted. Notwithstanding any such holding, alteration, or interpretation, the remainder of the provisions of the Joint Plan shall remain in full force and effect and shall in no way be affected, impaired, or invalidated by such holding, alteration, or interpretation. The Confirmation Order shall constitute a judicial determination, and shall provide that each term and provision of the Joint Plan, as it may have been amended or modified in accordance with the foregoing, is valid, non-severable and enforceable pursuant to its terms.

W. Revocation, Withdrawal, or Non-Consummation

Debtors and Creditors' Committee reserve the right to revoke or withdraw the Joint Plan as to any or all of Debtors prior to the Confirmation Date and to file amended plans of reorganization. If Debtors or Creditors' Committee revoke or withdraw the Joint Plan as to any or all of Debtors, or if confirmation or consummation of the Joint Plan as to any or all of Debtors does not occur, then, with respect to such Debtors: (i) the Joint Plan shall be null and void in all respects, (ii) any settlement or compromise embodied in the Joint Plan (including the fixing or limiting to an amount certain any Claim or Class of Claims), assumption or rejection of executory contracts or leases effected by the Joint Plan, and any document or agreement

executed pursuant to the Joint Plan, shall be deemed null and void, and (iii) nothing contained in the Joint Plan shall (a) constitute or deemed to constitute a waiver or release of any Claims by or against, or any Interests in, such Debtors or any other Person, or (b) prejudice in any manner the rights of such Debtors or any other Person, or (c) constitute an admission of any sort by such Debtors or any other Person.

X. Plan Supplement(s)

Any and all exhibits, lists, or schedules not filed with the Joint Plan shall be contained in the Plan Supplement(s) and filed with the Clerk of the Bankruptcy Court on or before the date that is ten (10) days prior to the first scheduled hearing to consider confirmation of the Joint Plan. Upon its filing with the Bankruptcy Court, the Plan Supplement may be inspected in the office of the Clerk of the Bankruptcy Court during normal Bankruptcy Court hours. Holders of Claims or Interests may obtain a copy of the Plan Supplement(s) upon written request to Debtors. Any Plan Supplement (and amendments thereto) filed by Debtors shall be deemed an integral part of the Joint Plan and shall be incorporated by reference as if fully set forth therein.

Y. Indemnification Obligations

Except as otherwise specifically limited or provided in the Joint Plan, any obligations or rights of Debtors or of Reorganized ETS to defend, indemnify, reimburse, limit, contribute to the losses, liabilities, or expenses of directors and officers pursuant to Debtors' or Reorganized ETS's certificates of incorporation, by-laws, policy of providing employee indemnification, applicable state law, or specific agreement in respect of any claims, demands, suits, causes of action, or proceedings against such directors and officers based upon any act or omission related to the directors' and officers' service with, for, or on behalf of Debtors prior to the Petition Date shall not survive confirmation of the Joint Plan, and shall be discharged.

Without limiting the foregoing, the indemnification obligations shall include, but not be limited to: (i) the reimbursement of any monies paid by directors and officers prior to the Effective Date relating to or arising from debts, liabilities, or other obligations for which Debtors are or were directly obligated; and (ii) the reimbursement or payment of any attorneys' fees and expenses incurred by the directors and officers to and including the Effective Date due to, among other things, the commencement of the Chapter 11 Cases, the commencement of litigation based upon guaranties executed, by the directors and officers, or any other matters arising due to the directors and officers' alleged liability for certain of Debtors' debts, liabilities or other obligations.

Z. Term of Injunctions or Stays

Unless otherwise provided in the Joint Plan, in the Confirmation Order, or in any other order of the Bankruptcy Court, all injunctions or stays provided for in the Chapter 11 Cases under sections 105 or 362 of the Bankruptcy Code or otherwise, and extant on the Confirmation Date, shall remain in full force and effect until the Effective Date and thereafter, to the extent required to enforce the terms and provisions of the Joint Plan.

AA. Governing Law

Unless a rule of law or procedure is supplied by federal law, including the Bankruptcy Code and Bankruptcy Rules: (i) the construction and implementation of the Joint Plan and any agreements, documents, and instruments executed in connection with the Joint Plan; and (ii) corporate governance matters shall be governed by the laws of the State of Delaware, without giving effect to the principles of conflicts of law.

BB. Retention of Jurisdiction

On the Effective Date, each Debtor, its property and operations shall be released from the custody, control and jurisdiction of the Bankruptcy Court. However, pursuant to sections 105(a) and 1142 of the Bankruptcy Code, and notwithstanding entry of the Confirmation Order and occurrence of the Effective Date, the Bankruptcy Court shall, to the fullest extent permitted by law, retain exclusive jurisdiction over all matters arising out of, or related to, the Chapter 11 Cases and the Joint Plan, including, but not limited to (i) to hear and determine pending applications for the assumption or rejection of executory contracts and unexpired leases (including those assumed or rejected under the Joint Plan) and the allowance of Claims resulting therefrom; (ii) to enter such orders as may be necessary or appropriate to implement or consummate the provisions of the Joint Plan and all contracts, instruments, releases, indentures and other agreements or documents created in connection with the Joint Plan; (iii) to determine any and all adversary proceedings, applications and contested matters, including those commenced by the trustee of the Litigation Trust; (iv) to ensure that Distributions to Holders of Allowed Claims are accomplished as provided in the Joint Plan; (v) to hear and determine any timely objections to any Claims filed, both before and after the Effective Date, including any objections to the classification of any Claim, and to allow or disallow any Disputed Claim, in whole or in part; (vi) to enter and implement such orders as may be appropriate in the event the Confirmation Order is for any reason stayed, revoked, modified, or vacated; (vii) to issue such orders in aid of execution of the Joint Plan, to the extent authorized by section 1142 of the Bankruptcy Code; (viii) to consider any modifications of the Joint Plan, to cure any defects or omissions, or reconcile any inconsistency in the Joint Plan or in any order of the Bankruptcy Court, including, without limitation, the Confirmation Order; (ix) to hear and determine all applications for awards of compensation for services rendered and reimbursement of expenses incurred prior to the Effective Date; (x) to hear and determine disputes arising in connection with the interpretation, implementation, or enforcement of the Joint Plan; (xi) to issue injunctions, enter and implement other orders or take such other actions as may be necessary or appropriate to restrain interference by any entity with consummation or enforcement of the Joint Plan, except as otherwise provided in the Joint Plan; (xii) to determine any other matters that may arise in connection with or relate to the Joint Plan, the Disclosure Statement, the Confirmation Order or any other agreement or document created in connection with the Joint Plan or the Disclosure Statement; (xiii) to hear and determine matters concerning state, local and federal taxes in accordance with sections 346, 505 and 1146 of the Bankruptcy Code; (xiv) to hear any other matter not inconsistent with the Bankruptcy Code; and (xv) to enter a final decree closing the Chapter 11 Cases.

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ARTICLE V

DISTRIBUTIONS UNDER THE JOINT PLAN

A. **Requirement for Allowance of Claims**

No payments or other Distributions shall be made on account of any Claim to the extent it is not an Allowed Claim.

B. **Funds for Distribution**

The funds utilized to make the Cash Distributions hereunder have been and will continue to be generated by, among other things, the operation of Debtors' businesses and asset dispositions.

C. **Time and Method of Distribution**

Unless otherwise set forth herein, all Distribution to Holders of Allowed Claims under the Joint Plan shall be made on the Distribution Date. Distributions with respect to each Allowed Claim shall be made solely to the Holder of such Claim as of the Record Date.

D. **Interest on Claims**

Unless otherwise specifically provided for in the Joint Plan or the Confirmation Order, or required by applicable bankruptcy law, postpetition interest shall not accrue on Claims, and no Holder of a Claim shall be entitled to interest accruing on or after the Petition Date on any Claim. Interest shall not accrue or be paid upon any Disputed Claim in respect of the period from the Petition Date to the date a final distribution is made thereon if and after such Disputed Claim becomes an Allowed Claim.

E. **Delivery of Distributions and Undeliverable or Unclaimed Distributions**

1. **Delivery of Distributions in General**

Distributions to Holders of Allowed Claims shall be made by Disbursing Agent or the appropriate agent or servicer, as the case may be: (a) at the addresses set forth on the proofs of Claim filed by such Holders (or at the last known addresses of such Holders if no proof of Claim is filed or if Debtors have been notified of a change of address); (b) at the addresses set forth in any written notices of address changes delivered to Disbursing Agent after the date of any related proof of Claim; (c) at the addresses reflected in the Schedules if no proof of Claim has been filed and Disbursing Agent, as the case may be, has not received a written notice of a change of address; (d) other records of Debtors or Disbursing Agent at the time of the Distribution; or (e) in the case of the Holder of a Claim that is governed by an agreement and is administered by an agent or servicer, at the addresses contained in the official records of such agent or servicer. Disbursing Agent shall have no obligation to recognize the transfer of, or the sale of any portion or all of, any Allowed Claim that occurs after the close of business on the Distribution Record Date.

2. Undeliverable and Unclaimed Distributions

If the Distribution to any Holder of an Allowed Claim is returned to Disbursing Agent as undeliverable or is otherwise unclaimed, no further Distributions shall be made to such Holder unless and until the Disbursing Agent is notified in writing of such Holder's then current address. Undeliverable and unclaimed Distributions shall be deposited in a segregated account, designated as an "Unclaimed Distribution Reserve" for the benefit of all such similarly situated Persons until such time as a Distribution becomes deliverable or is claimed.

Any Holder of an Allowed Claim that does not assert a Claim pursuant to the Joint Plan for an undeliverable or unclaimed Distribution within one year after the Distribution Date with respect to such Claim shall be deemed to have forfeited its claim for such undeliverable or unclaimed Distribution and shall be forever barred and enjoined from asserting any claim for an undeliverable or unclaimed Distribution against Debtors and the Estates, Disbursing Agent, Reorganized ETS, or their property. In such cases, any Cash, Reorganized ETS Stock or other property held in an Unclaimed Distribution Reserve shall constitute an Excess Reserve. Nothing contained in the Joint Plan shall require any Disbursing Agent, to attempt to locate any Holder of an Allowed Claim.

F. Means of Cash Payment

Cash payments under the Joint Plan shall be in U.S. dollars and shall be made, at the option and in the sole discretion of Disbursing Agent, as the case may be, by (i) checks drawn on or (ii) wire transfers from a domestic bank selected by Disbursing Agent. Cash payments to foreign Creditors may be made at the option of Disbursing Agent, in such funds and by such means as are necessary or customary in a particular foreign jurisdiction.

Checks issued in respect of Distributions under the Joint Plan will be null and void if not negotiated within ninety (90) days after the date of issuance. Any amounts paid to Disbursing Agent in respect of such check will be returned to Reorganized ETS by Disbursing Agent and such checks will be voided. Requests for reissuance of any check will be made directly to Disbursing Agent by the Holder of an Allowed Claim with respect to which such check was originally issued. Any claim in respect of such check must be made before the later of (i) the second (2^{nd}) anniversary of the Effective Date or (ii) ninety (90) days after the issuance of such check, if such check represents a final Distribution under the Joint Plan on account of such Claim. After such date, all claims in respect of voided checks and the underlying Distributions will be discharged and forever barred.

G. Surrender of Securities or Instruments

On or before the Distribution Date, or as soon thereafter as is practicable, each Holder of a promissory note or other instrument evidencing a Claim that is not being reinstated (a "Certificate") other than a Payphone Investor shall surrender such Certificate to Disbursing Agent, or, with respect to indebtedness that is governed by an agreement, the respective agent or servicer, as the case may be, and such Certificate shall be canceled. No Distribution under the Joint Plan shall be made to or on behalf of any such Holder unless and until such Certificate is received by Disbursing Agent or the respective agent or servicer, as the case may be, or the unavailability of such Certificate is reasonably established to the satisfaction of the Disbursing

Agent or the respective agent or servicer, as the case may be. Any such Holder who fails to surrender or cause to be surrendered such Certificate or fails to execute and deliver an affidavit of and indemnity reasonably satisfactory to Disbursing Agent or the respective agent or servicer, as the case may be, prior to the second anniversary of the Effective Date, shall be deemed to have forfeited all rights, kind Claims in respect of such Certificate and shall not participate in any Distribution and: (i) all Cash in respect of such forfeited Distribution, including interest accrued thereon, shall constitute an Excess Reserve, and (ii) all Reorganized ETS Stock and in respect of such forfeited Distribution shall constitute an Excess Reserve.

H. Setoffs

Debtors or Reorganized ETS may, but shall not be required to, set off against any Claim Distributions to be made under the Joint Plan on account of the Claim, claims of any nature whatsoever that Debtors or Reorganized ETS may have against the Holder thereof, but neither the failure to do so nor the allowance of any Claim under the Joint Plan shall constitute a waiver or release of any such claim that Debtors or Reorganized Companies may have against such Holder.

I. Fractional Dollars; De Minimis Distributions

Any other provision of the Joint Plan notwithstanding, payments of fractions of dollars or fractions of shares will not be made. Whenever any payment of a fraction of a dollar under the Joint Plan would otherwise be called for, the actual payment made will reflect a rounding of the fraction in the nearest whole dollar (up or down), with half-dollars rounded down, Disbursing Agent, or any agent or servicer, as the case may be, will not make any payment of less than five dollars ($5.00) with respect to any Allowed Claim, unless a request therefor is made in writing to the Disbursing Agent or agent or servicer, as the case may be. Fractional shares of Reorganized ETS Stock will be rounded to the next greater or lower number of shares, as follows: fractions of one-half (½) will be rounded to the next lower whole number or to zero, as the case may be, without compensation for such fraction.

ARTICLE VI

PROCEDURES FOR RESOLVING DISPUTED, CONTINGENT, AND UNLIQUIDATED CLAIMS

A. Objection Deadline; Prosecution of Objections

As soon as practicable, but in no event later than two years after the Effective Date (unless extended by order of the Bankruptcy Court), Debtors or Reorganized ETS, as the case may be, or any other party-in-interest may file objections to Claims (including any Administrative Expense Claim, Tax Claim, Priority Non-Tax Claim, Secured Claim, General Unsecured Claim or Payphone Investor Claim) with the Bankruptcy Court and serve such objections upon Holders of each of the Claims to which objections are made. Nothing contained in the Joint Plan, however, will limit Reorganized ETS's right to object to Claims, if any, filed or amended after the Effective Date. Reorganized ETS and such other party-in-interest (to the extent applicable) shall be authorized to, and shall, resolve all Disputed Claims by withdrawing

or settling such objections thereto, or by litigating to judgment in the Bankruptcy Court or such other Bankruptcy Court having jurisdiction the validity, nature, and/or amount thereof.

B. No Distributions Pending Allowance

Notwithstanding any other provision of the Joint Plan, no payments or Distributions will be made with respect to all or any portion of a Disputed Claim unless and until all objections to such Disputed Claim have been settled or withdrawn or have been determined by Final Order, and the Disputed Claim, or some portion thereof, has become an Allowed Claim.

C. Reserves for Disputed Claims

Except to the extent the Bankruptcy Court shall determine that a lesser amount is adequate, Disbursing Agent shall deposit in segregated interest bearing escrow accounts for each Class or category of Claims in which there are Disputed Claims, Cash, and, if appropriate, shares of Reorganized ETS Stock equal to the Distributions that would have been made to Holders of Disputed Claims in such Class or category if such Claims were Allowed Claims in the Adjusted Amount. Shares of Reorganized ETS Stock held in the Disputed Claims Reserve Accounts shall not be deemed to have been "issued."

All interest and earnings on funds deposited in the Disputed Claims Reserve Accounts shall be held in trust in the Disputed Claims Reserve Accounts and shall be distributed only in the manner described in the Joint Plan.

If after the Effective Date any dividends or other distributions would have been paid on, or any property would have been issued in exchange for or on account of shares of Reorganized Stock held by the Disbursing Agent in the Disputed Claims Reserve Accounts if such shares were "issued" shares of Reorganized ETS Stock, then an amount of Cash or other property equal to the dividends, distributions or other property that would have been paid on or issued in exchange for or on account of such shares shall be transferred by Reorganized ETS to Disbursing Agent at the time such dividends, distributions or other property are paid or issued to holders of Reorganized ETS Stock and shall be held by the Disbursing Agent in the Disputed Claims Reserve Account, and each holder of a Disputed Claim that becomes an Allowed Claim after the Effective Date and was otherwise entitled to receive a Distribution of Reorganized ETS Stock shall receive the same share of the dividends, distributions or other property distributed as a result of such event that such holder would have received if its Claim as ultimately allowed had been allowed as of the Effective Date net of any taxes or other applicable charges required to be paid by the Disbursing Agent in respect thereof.

At such time as all or any portion of a Disputed Claim becomes an Allowed Claim, the Distributions reserved for such Disputed Claim or such portion (including interest and dividends at the time such dividends, distributions or other property are paid or issued to holders and in the case of Reorganized ETS Stock issued at the request of Disbursing Agent of Reorganized ETS Stock, earned thereon or property distributed on account thereof) shall be released from the appropriate Disputed Claims Reserve Account and paid or distributed, as the case may be, by the Disbursing Agent to the Holder of such Allowed Claim, net of any taxes or other applicable charges required to be paid by the Disbursing Agent in respect thereof. At such time as all or any portion of any Disputed Claim is determined not to be an Allowed Claim, the Distribution

reserved for such Disputed Claim or such portion (including such interest and dividend thereon or property distributed on account thereof) shall be released from the appropriate Disputed Claims Reserve Account and shall be held by the Disbursing Agent as an Excess Reserve.

D. Excess Reserves

All Excess Reserves arising from the Disputed Claims Reserve Account with respect to Class 3 or Unclaimed Distributions with respect to Class 3 shall be transferred by Disbursing Agent to the Litigation Trust, and shall thereafter be held in the Litigation Trust until such time as there is no Cash in the Disputed Claims Reserve Account with respect to Class 3, at which time such Excess Reserves shall be distributed solely to the Holders of Allowed Class 3 Claims based upon each such Holder's pro rata portion of such Excess Reserves. All other Excess Reserves that are Cash shall be held by the Disbursing Agent until such time as there is no Cash in the Disputed Claims Reserve Accounts with respect to all Classes and categories of Claims other than Class 3, at which time the Disbursing Agent shall pay or transfer such Excess Reserves to Reorganized ETS. All Excess Reserves that are shares of Reorganized ETS Stock shall be held by the Disbursing Agent, and at such time as no shares of Reorganized ETS Stock remain in the Disputed Claims Reserve Account with respect to Class 4, such shares of Reorganized ETS Stock shall be transferred by the Disbursing Agent to Reorganized ETS and cancelled.

ARTICLE VII

TREATMENT OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

Under section 365 of the Bankruptcy Code, Debtors have the right, subject to Bankruptcy Court approval, to assume, assume and assign or reject any executory contracts or unexpired leases. If a Debtor rejects an executory contract or unexpired lease that was entered into before the Petition Date, the contract will be treated as if it had been breached on the date immediately preceding the Petition Date, and the other party to the agreement may assert a Class 3 General Unsecured Claim for damages incurred as a result of the rejection. In the case of rejection of employment agreements and real property leases, damages are subject to certain limitations imposed by section 502 of the Bankruptcy Code. Debtors are unaware of any actual or potential claims arising from rejection of an employment agreements. Claims arising from rejection of branch office leases and other facility leases are not material.

A. Assumed Contracts and Leases; Related Payments

All executory contracts and unexpired leases identified in Exhibit 1 to the Joint Plan shall be deemed automatically assumed as of the Effective Date. The Confirmation Order shall constitute an order of the Bankruptcy Court approving such assumptions, pursuant to section 365 the Bankruptcy Code, as of the Confirmation Date. Any and all executory contracts and leases assumed by Debtors shall be deemed assigned to Reorganized ETS as of the Effective Date and the Confirmation Order shall be deemed to approve such assignment.

On the Distribution Date, or as soon as practicable thereafter, Debtor will pay amounts necessary to cure any monetary amounts existing under each executory contract and unexpired lease to be assumed under the Joint Plan as required by section 365(b)(1) of the Bankruptcy Code, such other treatment or agreed to by the party to such contract or lease and Debtors. In the event of a dispute regarding: (i) the nature or the amount of any cure; (ii) the ability of the applicable Reorganized ETS to provide "adequate assurance of future performance" (within the meaning of section 365 of the Bankruptcy Code) under the contract or lease to be assumed; or (iii) any other matter pertaining to assumption, payment of the amount shall occur following the entry of a Final Order of the Bankruptcy Court resolving the dispute and approving the assumption and, as the case may be, assignment.

B. Rejected Contracts and Leases; Bar to Rejection Damages

Except as otherwise provided in the Joint Plan, or in any contract, instrument, release, or other agreement or document entered into in connection with the Joint Plan, each of the executory contracts and unexpired leases to which any Debtor is a party, including, without limitation, the executory contracts and unexpired leases identified on Exhibit 2 to the Joint Plan, to the extent such contracts or leases are executory contracts or unexpired leases, will be deemed automatically rejected by the applicable Debtor on the Confirmation Date, unless such contract or lease previously shall have: (i) been assumed by Debtors (including, but not limited to, those executory contracts and unexpired leases assumed and assigned to purchasers of Debtors' assets during the pendency of the Chapter 11 Cases) or (ii) expired or terminated pursuant to its own terms; *provided, however*, that nothing contained in the Joint Plan shall constitute an admission by any Debtor that any such contract or lease is an executory contract or unexpired lease or that any Debtor or its successors and assigns has any liability thereunder. The Confirmation Order shall constitute an order of the Bankruptcy Court approving the rejections of contracts and Leases described in the Joint Plan, pursuant to section 365 of the Bankruptcy Code, as of the Confirmation Date.

If the rejection of an executory contract or unexpired lease pursuant to Article VII of the Joint Plan gives rise to a Claim by the other party or parties to such contract or lease, such Claim will be forever the barred and shall not be enforceable against the applicable Debtors or their Estates, Reorganized ETS, or its respective successors or properties unless a proof of claim is filed and served on counsel for Debtors within 30 days after service of the Confirmation Order or such other date as prescribed by the Bankruptcy Court.

C. Compensation and Benefit Programs

Except as otherwise provided in the Joint Plan, all employee compensation and benefit plans of Debtors, including, without limitation, programs subject to sections 1114 and 1129(a)(13) of the Bankruptcy Code entered into before or after the Petition Date and not since terminated, shall be deemed to be, and shall be treated as if they were, executory contracts and shall be assumed automatically as of the Effective Date, but only to the extent that rights under such programs are held by Debtors or Persons who are employees of Debtors as of the Confirmation Date, and Debtors' obligations under such programs to Persons who are employees of Debtors on the Confirmation Date, shall survive confirmation of the Joint Plan, except for: (i) executory contracts or Benefit Plans listed on Exhibit 2 to the Joint Plan which shall be deemed automatically rejected on the Confirmation Plan (to the extent such rejection does not

violate sections 1114 and 1129(a)(13) of the Bankruptcy Code); and (ii) such executory contracts or Benefit Plans as have previously been rejected, are the subject of a motion to reject, or rights thereunder have been specifically waived by the beneficiaries of any Benefit Plans or contracts, provided, however, that Debtors' obligations, if any, to pay all "retiree benefits" as defined in section 1114(a) of the Bankruptcy Code shall continue.

Notwithstanding the foregoing, the Employment Agreements to be entered into on the Effective Date shall amend and supersede any other employment agreements, stock incentive plans, and severance plans with or for the benefit of those employees who are parties to the Employment Agreements.

ARTICLE VIII

MISCELLANEOUS MATTERS

A. Preservation of Rights of Action

Except as otherwise provided in the Joint Plan or in the Confirmation Order, or in any contract, instrument, release, or other agreement entered into in connection with the Joint Plan, in accordance with section 1123(b) of the Bankruptcy Code, Reorganized ETS and/or the trustee of the Litigation Trust or their respective successors may pursue any claim or cause of action, as appropriate, in accordance with the best interests of Reorganized ETS or its respective successors who hold such rights. The substantive consolidation of Debtors and their Estates pursuant to the Substantive Consolidation Order and Article IV.I. of the Joint Plan shall not, and shall not be deemed to, prejudice the rights of Debtors, Reorganized ETS and/or the trustee of the Litigation Trust to pursue any claim or cause of action, which shall survive entry of the Substantive Consolidation Order for the benefit of Debtors, their Estates, and Reorganized ETS as if there had been no substantive consolidation of Debtors and their Estates.

From and after the Confirmation Date, the Debtors and/or the trustee of the Litigation Trust shall, as a representative of Debtors' Estates, litigate avoidance or recovery actions under sections 544, 545, 547, 548, 549, 550, 551 and 553 of the Bankruptcy Code.

B. Withholding and Reporting Requirements

In connection with the Joint Plan and all Distributions, Disbursing Agent shall, to the extent applicable, comply with all withholding and reporting requirements imposed by any federal, state, local, or foreign taxing or securities regulatory authority. Disbursing Agent shall be authorized to take all actions as may be necessary or appropriate to comply therewith.

C. Conditions to the Effective Date

The following are conditions precedent to the Effective Date unless waived in accordance with Article VIII.C. of the Joint Plan:

1. the Bankruptcy Court shall have entered an order approving the Disclosure Statement as containing adequate

information within the meaning of section 1125 of the Bankruptcy Code.

2. the Confirmation Date shall have occurred and the Confirmation Order, in form and substance reasonably acceptable to Debtors and Creditors' Committee, confirming the Joint Plan, as the same may have been modified, shall have been entered and shall, among other things, provide that:

   a. Debtors are authorized and directed to take all actions necessary or appropriate to enter into, implement and consummate the instruments, releases, and other agreements or documents created in connection with the Joint Plan;

   b. the provisions of the Confirmation Order are nonseverable and mutually dependent; and

   c. all executory contracts or unexpired leases assumed and assigned by Debtors during the Chapter 11 Cases shall remain in full force and effect for the benefit of the assignee(s) thereof, notwithstanding any provision in such contract or lease (including those described in sections 365(b)(2) and (f) of the Bankruptcy Code) that prohibits such assignment or transfer or that enables, permits or requires termination of such contract or lease.

3. the Confirmation Order shall have become a Final Order.

4. the Declaratory Judgment Action shall have been resolved pursuant to a Final Order in a manner acceptable to Debtors and Creditors' Committee, which permits the treatment of Payphone Investor Claims and all other transactions in this Joint Plan and determines that Debtors shall have authority to sell, convey or assign the payphones that are subject to the Payphone Investor Agreements.

5. the Debtors shall be able to effectuate all Cash Distributions required to be made on the Distribution Date.

6. all documents required to implement the Joint Plan shall have been executed in form and substance reasonably satisfactory to Debtors and Creditors' Committee.

The conditions set forth in Article VIII of the Joint Plan may be waived in whole or in part by Debtors and the Creditors' Committee, without notice to the parties-in-interest or the Bankruptcy Court and without a hearing.

D. Modifications and Amendments

Debtors and Creditors' Committee may alter, amend, or modify the Joint Plan or any Exhibits thereto under section 1127(a) of the Bankruptcy Code at any time prior to the Confirmation Date. After the Confirmation Date and prior to "substantial consummation" of the Joint Plan, as defined in section 1101(2) of the Bankruptcy Code, Debtors may, under section 1127(b) of the Bankruptcy Code, institute proceedings in the Bankruptcy Court to remedy any defect or omission or reconcile any inconsistencies in the Joint Plan, the Disclosure Statement, or the Confirmation Order, and such matters as may be necessary to carry out the purpose and effect of the Joint Plan so long as such proceedings do not adversely affect the treatment of holders of Claims or Interests under the Joint Plan; *provided, however,* that prior notice of such proceedings shall be served in accordance with the Bankruptcy Rules or order of the Bankruptcy Court.

ARTICLE IX

EFFECTS OF CONFIRMATION

A. Binding Effect

The Joint Plan shall be binding upon and inure to the benefit of Debtors, all present and former Holders of Claims and Interests, and their respective successors and assigns, including, but not limited to, Reorganized ETS.

B. Discharge of the Debtors and Injunction

All consideration distributed under the Joint Plan shall be in exchange for, and in complete satisfaction, settlement, discharge, and release of, all Claims of any nature whatsoever against any Debtor or against any of its assets or properties arising on or before the Effective Date. Except as otherwise expressly provided in the Joint Plan or in the Confirmation Order, entry of the Confirmation Order shall act as a discharge of all Claims against, and Interests in, each of Debtors, such Debtor's assets, and its respective properties, arising at any time before the entry of the Confirmation Order, regardless of whether a proof of Claim therefor was filed, whether the Claim is Allowed, or whether the Holder thereof votes to accept the Joint Plan or is entitled to receive a Distribution thereunder. Upon entry of the Confirmation Order, any Holder of such discharged Claim or Interest shall be precluded from asserting against any of Debtors or any of its assets or properties any other or further Claim or Interest based upon any document, instrument, act, omission, transaction, or other activity of any kind or nature that occurred the Effective Date. The Confirmation Order shall be a judicial determination of discharge of all liabilities of Debtors, subject to the occurrence of the Effective Date.

In accordance with section 524 of the Bankruptcy Code, the discharge provided by this section and section 1141 of the Bankruptcy Code shall act as an injunction against the

commencement or continuation, in any manner or in any place, of any action, employment of process, or act to collect, offset, or recover the Claims and Interests discharged by the Joint Plan. Except as otherwise expressly provided in the Joint Plan or in the Confirmation Order, all Persons who have held, hold, or may hold Claims against, or Interests in, any of Debtors are permanently enjoined, on and after the Effective Date, from taking any of the following actions against any Debtor, any Estate, Reorganized ETS, the United States Trustee, or any of their property on account of any such Claims or Interests: (i) commencing or continuing in any manner or in any place, action, or other proceeding of any kind with respect to any such Claim or Interest, (ii) enforcing, attaching, collecting, or recovering in any manner or means any judgment, award, decree, or order on account of any such Claim or Interest, (iii) creating, perfecting, or enforcing any lien or encumbrance of any kind, (iv) asserting any right of setoff, subrogation, or recoupment of any kind against any debt, liability, or obligation due from any Debtor or against the property or interests in property of any Debtor on account of any such Claim or Interest, and (v) commencing or continuing, in any manner or in any place that does not comply with or is inconsistent with the provisions of the Joint Plan; *provided, however*, that nothing contained in the Joint Plan shall preclude such Persons from exercising their rights pursuant to and consistent with the terms of the Joint Plan. The foregoing injunction will extend to successors of Debtors (including, without limitation, Reorganized ETS) and their respective properties and interests in property.

C. Exculpation

The Debtors, their officers, employees on the Confirmation Date, members of Creditors' Committee appointed in these Chapter 11 Cases, and professionals retained with approval of the Bankruptcy Court in these Chapter 11 Cases shall not have or incur any liability to any person for any act taken or omission occurring on or after the Petition Date in connection with or related to the Debtors, included, but not limited to:

(i) the commencement and administration of the Chapter 11 Cases,

(ii) the operation of the Debtors during the pendency of the Chapter 11 Cases

(iii) formulating, preparing, disseminating, implementing, confirming, consummating or administering the Joint Plan (including solicitation of acceptances or rejections);

(iv) the Disclosure Statement or any contract, instrument, settlement or other agreement or document entered into or any taking taken or omitted to be taken with the Joint Plan; or

(v) any distributions made pursuant to the Joint Plan;

except for acts (a) constituting willful misconduct or gross negligence, and in all respects such parties shall be entitled to rely upon the advice of counsel with respect to their duties and responsibilities in these Chapter 11 Cases; and (b) that are the subject of any action or proceeding pending as of the Effective Date.

D. Dissolution of the Creditors' Committee

On the Effective Date, Creditors' Committee shall be dissolved and its members will be deemed released of all their duties, responsibilities, and obligations in connection with the Chapter 11 Cases or the Joint Plan and its implementation, and the retention or employment of Creditors' Committee's attorneys, accountants, and other agents shall terminate.

ARTICLE X

CONFIRMATION REQUEST

The Debtors and the Committee request confirmation of this Joint Plan under section 1129(b) of the Bankruptcy Code.

Dated: July 25, 2001.

ETS PAYPHONES, INC., et al.

By: _____
Name: Guy A. Longobardo
Title: Chief Executive Officer

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Counsel for the Official Committee of Unsecured Creditors

EXHIBIT 1

SCHEDULE OF ASSUMED LEASES AND EXECUTORY CONTRACTS

ASSUMED EXECUTORY CONTRACT

Party to the Agreement	Location (Subsidiary)	Name and Description of Agreement	Agreement Type
A Place for Your Stuff 2801 South Nova Road South Daytona, FL 32119	Sanford, FL	Lease dated February 18, 1997 governing self-storage unit #66B, located at 2801 South Nova Road, South Daytona, FL 32119; monthly rental is $42.45 and the term of the lease is month to month	RL
Absolute Alarm Systems 3910 Beriel Corpus Christi, TX 78418	Corpus Christi	Alarm services agreement, dated 10/1/99, between Absolute Alarm Systems and ETS Payphones for 3 years. $24.95 per month	SC
Adelphia Business Solutions of New Jersey, LLC 500 Atruim Drive Somerset, NJ 08873	Lithia Springs	Telephone service agreement (CLEC Agreement)	PSA
ADP Automatic Data Processing P.O. Box 9001006 Louisville, KY 40290	Lithia Springs	Auto Pay Sales Order dated 1/7/99 with estimated start date of 2/10/99 for payroll services for 52 weeks (pay cycles)	SC
ADT Security Services Inc. 1330 River Bend Drive #820 Dallas, TX 75247	Richardson, TX, (TSC Communications Corp.)	Commercial Sales Proposal/Agreements dated 6/4/98 and 11/1/99 between ADT Securities Services Inc., and TSC Communications Corporation for the lease of an alarm system. Both contracts expire five years after from the date service is operative. 6/4/98 agreement $130 per month; one dated 11/1/99 $150 per month	EQ
ADT Security Services Inc. 5400 West Rosecrans Hawthorne, CA 90250	Los Angeles, CA	Contract for fire and security alarm services between ETS Payphones, Inc. in Lithia Spring and ADT Security Services dated 3/16/99. Term of contract is for five years from the date service is operational and is automatically renewed yearly after that $65 per month	SC

ADT Security Systems PR, Inc. P.O. Box 386758 San Juan, Puerto Rico 00936-8758	PR, Inc. (Phoenix Telecom)	Commercial sales agreement dated April 9, 1999. Agreement provides for the purchase and installation of security equipment and the provision of security monitoring services at 1155 Jesus Pineiro, San Juan, PR 00920 for 5 years at $639 per year.	SC
Affiliated Leasing, Inc. P.O. Box 44509 Madison, WI 53744	Brooklyn, NY	Equipment lease dated June 15, 2000 and covering six M120 pay phones. Lease is for three years at $248.04 per month	EQ
All Storage 4152 Hollis Dr. Marianna, FL 32446	Waycross, GA	Lease for storage space	Non-Res
Alternative Mailing Systems, Inc. 3305 Breckinrige Blvd., Suite 100 Duluth, GA 30096	Lithia Springs	Lease agreement dated June 17, 1997; lease covers a PFE auto 2 folder inserter; term of lease is five years; monthly lease payment is $416.83	EQ
Alt's Mini-Storage 17104 Gardner's Lane Dubuque, IA 52001	Dubuque, IA (TSC Payphone)	Space Rental Contract dated February 19, 1998 on a month to month basis. $35 rent per month.	SC
Alt's Mini-Storage 17104 Gardner's Lane Dubuque, Iowa 52001	Dubuque, IA (TSC Payphone)	Space Rental Contract dated 2/19/98 for Unit No. 62 on a month to month basis $40 per month rent.	EQ
Amax Storage Facilitators 36 Dundas Road, P.O. Box 1288 Monticello, MN 55362	Monticello, MN	Lease Agreement for storage unit 605 between ETS Payphones, Inc. and Amax Storage Facilitators commencing on October 1, 1999 with a one month term and then on a month to month basis $70 per month rent.	EQ
American Store and Lock 8539 Monroe Road Charlotte, NC 28212	Charlotte, NC	Lease agreement covering facility located at 8539 Monroe Road, Suite 0103, Charlotte, NC 28212; lease is dated March 1, 2000 and commences on the same date expiring one year later on February 28, 2001; monthly rental payment is $260.00 per month	RL
American Store and Lock 8539 Monroe Road Charlotte, NC 28212	Charlotte, NC	Lease agreement covering facility located at 8539 Monroe Road, Suite 0104, Charlotte, NC 28212; lease is dated March 1, 2000 and commences on the same date expiring one year later on February 28, 2001; monthly rental payment is $165.00 per month	RL

American Store and Lock 8539 Monroe Road Charlotte, NC 28212	Charlotte, NC	Lease agreement covering facility located at 8539 Monroe Road, Suite 0106, Charlotte, NC 28212; lease is dated March 1, 2000 and commences on the same date expiring one year later on February 28, 2001; monthly rental payment is $165.00 per month	RL
American Store and Lock 8539 Monroe Road Charlotte, NC 28212	Charlotte, NC	Self storage rental agreement covering the facility located at 8539 Monroe Road, Bldg. A-303, Charlotte, NC 28212; lease is dated March 1, 2000, commences March 1, 2000 and continues month to month; monthly rental is $300.00.	RL
American Store and Lock 8539 Monroe Road Charlotte, NC 28212	Charlotte, NC	Office Lease for Suite 125, 8539 Monroe Rd., Charlotte, NC 28212	RL
Anchorage Condominium Association 6600 Estate Nazareth #37 St. Thomas, U.S.V.I. 00802	Virgin Islands (S&R Telecom)	Commercial lease dated June 1, 1999; commencing June 1, 1999 and terminating May 31, 2001; agreement covers storage room located at S-2 Anchorage Condominiums State Nazareth St. Thomas US Virgin Islands; monthly lease payments for the first year are $420.00, and for the second year are $440.00	RL
Anchorage Condominium Association 6600 Estate Nazareth #37 St. Thomas, U.S.V.I. 00802	Virgin Islands (S&R Telecom)	Commercial lease dated June 1, 1999; commencing June 1, 1999 and terminating May 31, 2001; agreement covers storage room located at S-1 Anchorage Condominiums State Nazareth St. Thomas US Virgin Islands; monthly lease payments for the first year are $420.00, and for the second year are $440.00	RL
Anchorage Condominium Association 6600 Estate Nazareth #37 St. Thomas, U.S.V.I. 00802	Virgin Islands (S&R Telecom)	Guaranty dated May 27, 1999, guaranty of lease between ETS Payphones of the Virgin Islands, dba S&R Telecom wherein ETS Payphones Inc. guaranteed the lease payments to Anchorage Condominium Association	RL

Anza Mailing Systems Inc. 111 New Edition Court Carey, North Carolina 27511	Cary, NC (Triangle)	Agreement for purchase of a power feed mail machine dated 4/17/98 between Triangle Telephone Company and Anza Mailing Systems. Also Maintenance Agreement dated 4/17/98. Annual fee $240. Machine located at 100-C Woodwind Industrial Dr., Cary, NC 27511	RL
APCC Services	Lithia Springs	Agreement renewal dated February 20, 2000. Agreement appoints APCC as its exclusive agent for billing and collection, including routine and ordinary course with respect to dial around compensation	PSA
Armored Transport Texas Inc. 2311 Motor Street Dallas, TX 75235	Corpus Christi	Armored Car Service Agreement dated 12/8/99 between Armored Transport Texas Inc., and ETS Payphones, Inc., for service at 5233 IH 37, Suite C5, Corpus Christi, TX 78408. The term was from 12/8/99 for one year and the contract renews for a year automatically	SC
Armored Transport, Inc. P.O. Box 15060 1612 West Pico Blvd. Los Angeles, CA 90015	Los Angeles, CA	Armored Car Service Agreement between Armored Transport, Inc. and ETS Payphones, Inc. in Lithia Springs, GA dated 7/8/1999 for service to ETS Payphones, 146 West 132nd Street, Los Angeles, CA 90061. Term of the contract was from 7/9/1999 for one year and thereafter from month to month $125 month	SC
Arrow Exterminators PO Box 1073 Lithia Springs 30122	Lithia Springs	Commercial pest control service agreement dated June 5, 2000. One-year agreement provides for pest control services at $125.00 per quarter	SC
Ascom Hasler Alternative Mailing Systems Inc. 3305 Breckinridge Blvd., Suite 112 Duluth,GA 30096	Lithia Springs	Equipment service agreement dated April 17, 2000. One year agreement commencing 5/4/2000 for installation and service of mail machine, scale and feeder. Annual fee $513	SC

Ascom Hasler Leasing P.O. Box 828 Deerfield, IL 60015	Lithia Springs	60-month lease of postage meter machine and postage scale dated 2/3/97. Monthly payment of $106.08 per month for the first year; $151.84 per month for every year thereafter. Lease No. 107182	SC
AT&T Corp 295 North Maple Ave. Basking Ridge, NJ 07920	Lithia Springs	AT&T Independent Private Payphone Owner Commision Agreement dated 10/25/99. Term is 3 years commencing 11/16/1999. Amendment No. 1 dated 9/6/2000. AT&T to pay commission to ETS Payphones for certain kinds of calls made on ETS phones. ETS to promote use of AT&T	SC
Atlanta Office Machines, Inc. 552 Cobb Parkway SE Marietta, GA 30062	Lithia Springs	Copier Maintenance Agreement between Atlanta Office Machines, Inc., (AOM) and ETS Payphones for a NP 6060 copier dated 3/17/98. Expiration date 2/23/99. The Agreement automatically renews	SC/EQ
Augusta Avenue Storage 1980 S. Georgia Pkwy. Waycross, GA 31501	Waycross, GA	Lease for storage space	Non-Res
Bank of America, NA 400 N. Ashley Dr., 8th Floor Tampa, FL 33602 Attn: V. President, Real Estate Services	Lake City, FL (Phoenix Telecom, LLC)	Office Lease dated December 29, 1999 for real property located at 150 W. Madison Street, Suite 101, Lake City, FL 32055. Lease commenced on January 1, 2000 and expires on December 31, 2000 and monthly lease payment are $847.00. Option to renew for three one-year terms.	EQ
BellSouth Mobility, Inc. 9559 Highway 5, Suite 201 Douglasville, GA 30135	Lithia Springs	Service agreement and addendum to service agreement dated 7/8/1999 for cellular services for mobile phone number 404-216-1858. Term is for twelve months, terminating on 7/7/2000. Monthly fee is $119.95	TD
BellSouth Mobility, Inc. 9559 Highway 5, Suite 201 Douglasville, GA 30135	Lithia Springs	Service agreement dated January 6, 2000. One year agreement for cellular phone services for mobile phone number 770-789-4264. Monthly fee is $92.90	SC

Blue Ridge Mountain Waters PO Box 48509 Atlanta, GA 30362	Lithia Springs	Equipment Lease and contract for services of water delivery, dated June 29, 2000. Month-to-month at $45 per month	SC
Brinkman Properties		Security Deposit #703	
Brink's Home Security 500 Clanton Rd. #F Charlotte, NC	Cary, NC	Alarm System contract between Brink's Home Security and ETS Payphones, Inc. for an alarm system located at 111-B Woodwinds Industrial Court, Cary, NC 27511. Term of contract is three years from the date in which the protective equipment becomes operational. After the three years the agreement automatically continues for successive one year renewal terms $27.95 monthly monitoring fee	SC
Business Telecom, Inc. (BTI) 4300 Six Forks Road Fifth Floor Raleigh, NC 27609	Lithia Springs	Mutual confidentiality and nondisclosure agreement dated 9/6/2000 between Business Telecom, Inc. (BTI) and ETS Payphones	SC
Cal Pacific Business Machines 230 West Florence Inglewood, CA 90301	Los Angeles, CA	Lease for copier (See Panasonic Communications lease listed below)	SC
Callaway Road Storage 2605 Callaway Rd. Tyler, TX 75707	Tyler, TX	Lease for storage space, Unit #738 for $86.00 per month	Non-Res
Cellular One Box 15067 San Juan, PR 00902	Puerto Rico (Phoenix Telecom)	Cellular One service agreement – corporate, dated June 7, 1999. Agreement provides for the provision of cellular service on a month-to-month basis; Amendment added 4 more cellular phones/pagers	CD
Cellular One Box 15067 San Juan, PR 00902	Puerto Rico (Phoenix Telecom)	Cellular One service agreement – corporate, dated May 29, 1999. Agreement provides for the provision of cellular service on a month-to-month basis Monthly fee about $24	SC
Central Storage 1019 Central Ave. Metiarie, LA 70001	Metiarie, LA	Lease for storage facility	Non-Res

Centrocamiones, Inc. PO Box 11411 Caparra Heights Station San Juan, Puerto Rico 00922	Puerto Rico (Phoenix Telecom)	Purchase Agreement for 2000 Ford E-150 dated 12/15/99. VIN is 14902. Agreement calls for 59 payments of $372.80 per month commencing on 1/14/2000	EQ
Chambers Development, LLC 4909 Ball Rd. Knoxville, TN 37919	Knoxville, TN	Lease agreement governing lease of 1,792 square foot office warehouse space located at 333-S Troy Circle, Knoxville, TN 37931; lease is dated August 8, 1998, one year lease commencing on August 1, 1998 and terminating on July 31, 1999; lease then converts to a month to month tenancy; rent was $800.00 per month subject to an adjustment based upon the consumer price index for subsequent years	SC
Charles E. Meyer d/b/a Hearst Plaza P.O. Box 763 Metairie, LA 70004	Metairie, LA	Gross commercial lease agreement dated February 21, 2000, 12 month lease commencing on March 1, 2000 expiring February 28, 2001 located at 4937 Hearst Street, Suite 1H, Metairie, LA 70004; monthly rental payment is $800.00	SC
Clearview Mini Storage 4408 Hearst Ave. Metiarie, LA	Metiarie, LA	Lease for storage facility	Non-Res
Comfort Inn 5487 West Moreland Plaza Douglasville, GA 30134	Lithia Springs, GA	Agreement between Comfort Inn and ETS Payphones for an exclusive arrangement for use of the Comfort Inn in Douglasville, GA and for certain prices and amenities. Dated 6/28/2000	TD
Comm-Wire, Inc. PO Box 420172 Atlanta, GA 30342 3230 Peachtree Corners Circle Norcross, GA	Lithia Springs	Equipment Maintenance Agreement between Comm-Wire, Inc. and ETS Payphones dated 6/17/97 for maintenance of the Legend R2 Telephone system. Term for one year and automatically renews for one year periods. $158.28 per month	RL
Conseco Finance Vendors Services Corp P.O. Box 957 Paramus, NJ 07652	Brooklyn, NY	Equipment Lease between Conseco Finance Venders Services Corp and Millicom Services Company for Toshiba Telephone Equipment located at 555 63rd St., Brooklyn, NY 11220	RL

Coral Telecom, Inc. 125 South Gadsden St. Suite 200 Tallahassee, FL 32301	Lithia Springs	1-800-YOU-SAVE Agreement between Coral Telecom and ETS Payphones, Inc. dated August 10, 2000 with a one year term, then month to month. ETS receives compensation for promoting use of the calling services accessed by the toll free number on its phones.	EQ
Cummins-Allison Corp P.O. Box 339, 891 Feehanville Drive Mt. Prospect, IL 60056	Garland, TX (Tel Serv)	Preventative Maintenace Inspection Agreement between Cummins-Allison Corp and TelServ Communications for a printer and communications equipment dated 10/1/91. Annual fee $640. Renews automatically annually	EQ
D & B No. 3, LLP P.O. Box 95605 Atlanta, GA 30347 1934 North Druid Hills Rd. Atlanta, GA 30319	Lithia Springs	Business lease dated July 14, 1999 governing the real property used as corporate headquarters office and warehouse. Lease is for 60 months commencing on September 1, 1999 and expiring on August 31, 2004. Base rent is $12,563.00 per month for the first year; $13,066.00 per month for the second year; $13,588.00 per month for the third year; $14,132.00 per month for the fourth year and $14,698.00 for the fifth year. Also $200 per month for water and sewer	CA
Danny Poindexter 5846 Siloam Rd. Siloam, NC 27047	Siloam, NC	Lease for office space located at 5801 Siloam Rd., Siloam, NC 27047. (This address used to be numbered 2773 Siloam Rd.)	EQ
De Lage Landen Financial Services P.O. Box 41601 Philadelphia, PA 19101-1601	Lithia Springs	Lease Agreement between De Lage Landen Financial Services and ETS Payphones, Inc. regarding PFE Mailing Equipment located at 561 Thornton Road, Suite K, Lithia Springs, GA 30122	RL
Diamond Security Systems, Inc. 100 NE Loop 410 Suite 150 San Antonio, TX 78216	San Antonio, TX (TSC Communications Corp.)	Customer Security System Monitoring Agreement (Commercial) between Diamond Security Systems Inc. and TSC Payphone or TSC Communications. Contract is not dated	EQ

Dunbar Armored 6027 N. 77th Street Milwaukee, WI	Waukesha, WI (Americom, Inc.)	Provision of armor car services.	EQ
East Group Properties, L.P. c/o FLC Management 88005 Overseas Highway Suite 9187 Islamorada, FL 33036 East Group Property Services, Inc. 6555 NW 9th Ave. Suite 104 Fort Lauderdale, FL 33309	Ft. Lauderdale, FL	Lease betwwen East Group Properties and ETS Payphones, Inc. dated 8/1/00 for property located at 5610 Northwest 12th Avenue, Suite 211, Fort Lauderdale, Florida 33309. The term is for two years beginning on or before 8/1/00. Base rent is $3,372/mo.	C
Ed Voyles Chrysler-Plymouth Chrysler Financial Co. LLC 789 Cobb Parkway Marietta, GA 30062	Lithia Springs	Motor Vehicle Lease Agreement for a 1999 Chrysler 300M VIN 819547 for the term beginning on 7/9/99 and ending 7/9/2002. $595.98 for 35 months. Residual value of $15,117.45	SC
Eddie's Mini Storage PO Box 427 Calera, OK 74730	Calera, OK	Lease for storage unit 16. Rent is $40 per month. Used to store inventory and equipment	SC
Ensley Mini Warehouses 110 East Nine Mile Road Pensacola, FL 32534	Florida	Lease Agreement for Unit No. 251 between ETS Payphones and Ensley Mini Warehouses. The term began on 10/20/1999 and continues month-to-month. Rent and tax $75.25 per month	PL
Ernest Communications, Inc. (ECI) 6475 Jimmy Carter Boulevard Suite 300 Norcross, GA 30071	Lithia Springs	Local Telephone Service Agreement with ETS Payphones, Inc. dated 8/23/2000. Term was 90 days from signing and then month to month.$28 flat fee plus state and municipal taxes	RL
Executive Risk Indemnity, Inc. 82 Hopmeadow Street Simsbury, CT 06070-7683	Lithia Springs	D&O Liability Insurance Policy No. 8165-4782 between Executive Risk Indemnity, Inc. and ETS Payphone, Inc. with an inception date of April 1, 2000 and expiration date of April 1, 2001. Premium was prepaid.	RL

FairCall Corporation 40 Northeast 7th Ave. Third Floor Delray Beach, FL 33483	Lithia Springs	Confidentiality Agreement between ETS Payphone and FairCall Corporation dated May 2, 2000 with an unlimited term	RL
FairCall Corporation 40 Northeast 7th Ave. Third Floor Delray Beach, FL 33483	Lithia Springs	FairCall Independent Agent Agreement regarding commissions to ETS Payphones, Inc. for use of operator services on ETS phones, dated 5/2/2000. Term is one year from FairCall's acceptance; FairCall signed on 5/5/2000	PSA
FedEx Corporate Services P.O. Box 1140 Memphis, TN 38101	Lithia Springs	FedEx automation agreement dated September 8, 2000. Agreement governs the use of an eltron printer and carries an indefinite term	C
Ford Motor Credit Company Commercial Lending Services P.O. Box 834101 Richardson, TX 75083 PO Box 152271 Irving, TX 75015-2271	Richardson, TX, (TSC Communications Corp.)	Commercial Lease Agreement (TRAC) dated March 13, 1998 with the following Supplements to Lease Agreement: 36-month lease; commenced June 1, 1998; 1998 Ford Ranger, VIN 36400 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20184 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 26555 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 26554 36-month lease; commenced April 1, 1998; 1998 Ford Ranger, VIN 11483 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20183 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 34799 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 06381 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20187 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20186	CA

Ford Motor Credit Company Commercial Lending Services P.O. Box 834101 Richardson, TX 75083 PO Box 152271 Irving, TX 75015-2271	Richardson, TX, (TSC Communications Corp.)	Commercial Lease Agreement (TRAC) dated March 13, 1998 with the following Supplements to Lease Agreement: 36-month lease; commenced June 1, 1998; 1998 Ford Ranger, VIN 36400 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20184 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 26555 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 26554 36-month lease; commenced April 1, 1998; 1998 Ford Ranger, VIN 11483 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20183 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 34799 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 06381 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20187 36-month lease; commenced April 1, 1998; 1998 Ford F150, VIN 20186	CA

Ford Motor Credit Company Commercial Lending Services P.O. Box 834101 Richardson, TX 75083 PO Box 152271 Irving, TX 75015-2271	Richardson, TX (TSC Communications Corp.)	Commercial Lease Agreement (TRAC) dated May 14, 1997 with the following Supplements to Lease Agreement: 48-month lease; commenced July 1, 1997, 1997 Ford F150, VIN 97923 48-month lease; commenced July 1, 1997; 1997 Ford F150, VIN 88376 48-month lease; commenced July 1, 1997; 1997 Ford Ranger, VIN 51724 48-month lease; commenced June 1, 1997; 1997 Ford Ranger, VIN 10717 48-month lease; commenced June 1, 1997; 1997 Ford F150, VIN 02623 48-month lease; commenced June 1, 1997; 1997 Ford RangerVIN 29938 48-month lease; commenced July 1, 1997; 1997 Ford Ranger, VIN 39426 48-month lease; commenced July 1, 1997; 1997 Ford Ranger, VIN 03491 36-month lease; commenced March 1, 1998; 1997 Ford Econoline Van, VIN 13202 36-month lease; commenced March 1, 1998; 1998 Ford Ranger, VIN 46442 36-month lease; commenced March 1, 1998; 1998 Ford Ranger, VIN 56486 48-month lease; commenced May 1, 1997; 1997 Ford F150, VIN 49391 48-month lease; commenced May 1, 1997; 1997 Ford F150, VIN 89555 48-month lease; commenced May 1, 1997; 1	C
G.J. Braun Corporation d/b/a Braun Enterprises 6671 Southwest Freeway Suite 750 Houston, TX 77074 Attn: Gabriel J. Braun, Manager	Houston, TX	First amendment to lease agreement between G.J. Braun Corporation and ETS Payphones, Inc., dated 7/20/2000. It covers the building at 927 Crosstimbers, Houston, TX 77022. Expiration date 8/31/2003. Original lease was dated 2/18/99. Rent $1,000 for 9/1/2000-8/31/2001; $1075 for next year and $1150 for next year, ending 8/31/2003	EQ

G.R. Ladd & Jean H. Ladd Glasgow Road Cary, NC 27511	Cary, NC (Triangle)	Lease Agreement between G.R. Ladd and Jean H. Ladd and Triangle Telephone for office/warehouse located at 111B Woodwinds Industrial Court, Cary, NC dated 9/13/93. Expiration 10/31/98. Tenant has option to renew for two periods of five years each. First Extended Term ends 10/31/2003 and rent is $2320. Second Extended Term would end 10/31/2008 and rent would be $2690	PL
Great America Leasing Corporation 2750 First Ave. NE Cedar Rapids, Iowa 52402	Lithia Springs	Lease Agreement No. #77722 for Canon NP-8530 copier, dated November 30, 1998. Lease is for 36 months at $262 per month	RL
Great America Leasing Corporation 2750 First Avenue N.E. Cedar Rapids, Iowa 52402	Lithia Springs	Lease Agreement No. 38237 for a Canon AP6650 copier dated 1/27/97. Term for 36 months at $261 per month	RL
Great America Leasing Corporation 2750 First Avenue N.E. P.O. Box 609 Cedar Rapids, Iowa 52406-0609	Lithia Springs	Lease Agreement No. 102773 between Great America Leasing Corporation and ETS Payphones for a Sharp AR-405 copier system dated 11/8/99 for 36 months at $329 per month	PL
GreatAmerica Leasing Corporation 2150 First Avenue, NE. Cedar Rapids, Iowa 52402	Lithia Springs	Lease Agreement between GreatAmerica Leasing Corporation and ETS Payphone Inc., dated 1/7/98 for a Canon NP-6060 Copier system. Rental is $230.75 per month for 36 months	EQ
Guardian Life Insurance Company of America 7 Hanover Square New York, NY 10004	Lithia Springs	Amendment to Group Policy No. G-00338223-FC dated 3/29/2000 effectIve 2/1/2000	EQ
Guardian Self Storage 9221 Eagle Ranch Road Alburqurque, New Mexico 87114	Albuquerque, NM	Lease Agreement for unit 447 located at 9221 Eagle Ranch Rd, Albuquerque, NM dated 3/1/2000. Renews month to month.Addendum dated 2/10/2000 for M49 at $88 per month	EQ

H. E. Butt Grocery Company 646 S. Main P. O. Box 839999 San Antonio, TX	Texas	Communication Agreement dated 09/05/91, 3 year term with automatic one year renewal	EQ
Home Depot	Lithia Springs	Deposit on account	EQ
Houston Power & Light	Texas	Securoty Deposit	EQ
Inter-tel Leasing, Inc 6955 Portwest Drive Suite 190 Houston, TX 77024 3170 Reps Miller Road Suite 100 Norcross, GA 30071	Lithia Springs	Telephone Lease Agreement with ETS Payphones, Inc. dated 11/12/99 for 60 months at $2481.05 per month. Seven Supplements to Equipment Lease for Additional Equipment (Add-ons) dated 3/3/2000 and require monthly rental payments totaling $1,804.99	C
Inter-tel Technologies, Inc 3170 Reps Miller Road Suite 100 Norcross, GA 30071	Lithia Springs	Total Lease Program Branch Agreement for installation, maintenance and warranty of equipment located at 1490 Westfork Rd. Suite G, Lithia Springs between Inter-tel Technologies, Inc. and ETS Payphones, Inc. dated November 12, 1999 and continuing for 60 months	PSA
Karen Hansen d/b/a Integrity Refreshments	Lithia Springs	Placement Form dated September 18, 1998. Five year agreement providing for snack and refreshment equipment for the company break room	EQ
KMC Telecom 3075 Breckinridge Blvd. #415 Duluth, GA	Lithia Springs	Letter Agreement with ETS Payphones for local dial tone dated 8/16/2000. Term is month to month. Flat rate of $28.50 per month per ANI	SC
Lanier Worldwide, Inc. 2300 Parklake Drive NE Atlanta, GA 30345-2979	Sanford, FL	Rental Agreement No. 2601025 for copier and full-service agreement. Contract is not dated and the term is month-to-month	SC

Lanier Worldwide, Inc 2150 Parklake Drive 4th Floor Atlanta, GA 30345	Metairie, Louisiana	Lease and Maintenance Agreement for copy machine between Lanier Worldwide, Inc. and Payphone Commissions Co., Inc. The term was from 3/1/2000 through 2/28/20001. This contract is reflected by an invoice dated 2/1/2000. $279 annual fee. Machine located at 4937 Hearst St., Suite 1-H, Metairie, LA	PSA
Loomis, Fargo & Co. 1080 NW 20th St. Miami, FL 33127	Davie, FL	Service Agreement, $30 - $32.40	SC
Loomis, Fargo & Co. 1610 Northeast, 4th Street Oklahoma City, OK 73117	Boswell, OK	Service Agreement between Loomis, Fargo & Co., and ETS Payphones Inc., dated 5/16/00 for transporting coins from 200 N. West Street, Boswell, Oklahoma 74727. The term of the contract ran from 5/19/00 for two years and extends automatically for two years, $500 per month	SC
Loomis, Fargo & Co. 1610 Northeast, 4th Street Oklahoma City, OK 73117	Boswell, OK	Service Agreement between Loomis, Fargo & Co., and ETS Payphones Inc., dated 6/1/00. The term of the contract was from 5/19/00 to 5/19/02. It covers a weekly pickup and delivery at the ETS Payphones location in Boswell, Oklahoma	SC
Loomis, Fargo & Co. 1800 West Broadway, Suite 3 Tempe, AZ 85281	Phoenix, AZ	Armored Car Service Agreement dated 5/12/00, signed 6/21/00. The term of the contract is from 5/12/00 for one year. It covers pickups and deliveries at the location in Phoenix, Arizona, 3106 W. Thomas Road, $135 per month	EQ/SC
Loomis, Fargo & Co. 315 12th Street Sacramento, CA 95814	Sacramento (ETS California)	Service Agreement between Loomis, Fargo & Co. and ETS Payphones of California, Inc. dated 7/1/1999. It covers service to the office at 2522 E Street, Sacramento, CA 95814 for one year. It automatically is extended for successive periods of one year, $125 per month	SC

Loomis, Fargo & Co. 564 West Burgess Road Pensacola, FL 32503	Cantonment, FL	Service Agreement between Loomis, Fargo & Co. and ETS Telephone Co. dated 9/24/1999 for armored car services. Term of contract was from 9/28/1999 for one year. Agreement automatically extends for successive periods of one year. It provides for service for the Cantonment, Florida office at 209 Rocky Road, $215 per month	SC
Loomis, Fargo & Co. 802-B North 12th Street Tampa, FL 33602	New Port Richey, FL	Armored Car Service Agreement between Loomis, Fargo & Co., and EPS Payphones dated 8/27/99. The term of the contract runs from 8/30/99 for one year and automatically renews for a year. It covers pickups and deliveries at the location at 6617 State Road 54, New Port Richey, FL 34653, $116 per month	SC
Manousos Maropakis 555 63rd Street Brooklyn, NY	Brooklyn, NY	Lease agreement with Cointel Communications Inc. Term is June 1, 1987 through May 31, 1992 with options to extend for one to five years; lease covers property located at 555 63rd Street, Brooklyn, NY; initial monthly rental was $3,300.00 subject to a 5% increase at each anniversary	SC
Mathusek Incorporated 50 McDermott Place Bergenfield, NJ 07621	Lithia Springs	Lease Agreement between Mathusek Incorporated and ETS Payphones	SC
Mini-Storage Units of Columbia County Route 18, Box 736-5 Lake City, FL 32025	Lake City, FL	Rental Agreement between Mini-Storage Units of Columbia County and ETS Payphones, Inc. for Unit 6 in Lake City commencing August 1, 2000 and continuing on a month to month basis. $101 per month	RL
Mpower Communications, Corp. 171 Sully's Trail Pittsford, NY 14534	Lithia Springs	Pay Station Agreement with ETS Payphones, Inc. dated 8/1/2000 It covers certain services provided by Mpower in Atlanta, Florida, and California including access lines and long distance service. 90 day trial period then 21 months more. Fees for access line range from $19 to $25 and other fees apply	RL

New York Local Telephone Inc.	(MSC)	Exclusive Local and International Long Distance Telephone Service Agreement dated 2/18/98 between NYLT, MSC National Inc. and ETS Payphones, Inc.	RL
NorAm Enterprises 141 East Broadway Suite 7 P.O. Box 128 City of Monticello, MN	Monticello, MN	12/27/99 Modification and Extension of Lease between NorAm Enterprises and ETM Payphones Inc.dated 7/1/99. The term of the lease is now from 1/1/00 to 12/31/01. For office located at 141 East Broadway, Suite 8, Monticello. (Earlier lease dated 7/1/99 was for Suite 6.) Rent $827.05 per month in 2000 and $884.94 in 2001	PSA
Off Broadway Partners c/o Howard Schwimmer 13200 Crossroads Parkway, N. #250 Industry, CA 91746	Los Angeles, CA	Standard industrial commercial tenant lease covering facility located at 146 West 132nd Street, Unit A, Los Angeles, CA 90061; lease is dated February 25, 1999, commences March 1, 1999 and expires February 28, 2001; base rental payments are $1617.00. Lease is in name of Chuck and Vickie Hoffman. Option to Extend dated 2/25/99 calls for the base rent to increase to $1,647 on 3/1/2001 and to $1,708 on 3/1/2002.	PSA
One Call Communications, Inc. D/B/A Opticom 801 Congressional Boulevard Suite 100 Carmel, Indiana 46032	Lithia Springs	Operator Services Agreement for long distance calls with ETS Payphones, Inc. dated 8/21/2000. The contract was to continue until Opticom recoups $204,831.41 of bonuses previously paid to ETS and then month to month. It was made pursuant to a Settlement Agreement dated 8/21/2000 resulting from an arbitration proceeding	RL

Orlando Flexspace Ltd. c/o Adler Management Services Inc. 125 S. Swoope Ave. Suite 103 Maitland, FL 32751 Adler Management Services, Inc. 1400 NW 107th Avenue Miami, FL 33172	Sanford, FL	Warehouse lease dated September 27, 1999, commencing October 4, 1999; 3 year lease terminating on October 31, 2002 governing space located at 504 Central Park Drive, Sanford, FL 32771; monthly lease payments are $1566.00 from 11/1/99 to 10/31/2000; $1628.64 from 11/1/2000 to 10/31/2001; and $1693.79 from 11/1/2001 to 10/31/2002.	PSA
PageNet P O. Box 26367 Salt Lake City, UT	Cantonment, FL	Agreement for pagers, Account NO. 051-036866	RL
Panasonic Communications & Systems Company Lease Administration Center P O. Box 7023 Troy, Michigan 48007-7023	Los Angeles, CA	Lease Agreement No. 1504559 for a Panasonic copier located at 146 West 132nd Street, No. A, Los Angeles, CA 90061 Lease of copier, dated March 23, 1999. Lease is for 36 months at $89.85 per month	EQ/SC
Plants by Design 3044 Wallace Lake Rd. Douglasville, GA 30135	Lithia Springs	Rental and maintenance agreement dated March 17, 2000. Agreement provides for rental of houseplants and associated maintenance of same. The agreement is month to month with a $210.00 per month maintenance fee	EQ
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease Agreement of 1998 Dodge Ram, VIN 109712, dated 8/30/99. Agreement provides for 36 payments of $491 commencing on 9/1/99. Residual is $3,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease Agreement of 1999 Ford E250 Van, VIN 79117, dated 8/30/99. Agreement provides for 48 payments of $419 per month commencing on 9/1/99. Residual is $4,000	PL

Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease Agreement of a 1999 Ford E250 Van, VIN 04213, dated 8/30/99. Agreement provides for 48 payments of $438 per month commencing on 9/1/99. Residual is $4,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease of 1997 Dodge Ram pickup, VIN 587526, dated 8/30/99. Agreement provides for 36 payments of $465 per month commencing on 9/1/99. Residual is $3,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease of 1998 Dodge Ram Van, VIN 109704, dated 8/30/99. Agreement provides for 48 payments of $368 per month, commencing on 9/1/99. Residual is $3,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease of 1999 Ford E250 Pickup, VIN 04223, dated 8/30/99. Agreement provides for 43 payments of $474 per month, commencing on 9/1/99. Residual is $4,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease of 1999 Jeep Cherokee, VIN 511370, dated 8/30/99. Agreement provides for 44 payments of $378 per month, commencing on 9/1/99. Residual is $4,000	PL
Popular Leasing and Rental, Inc. PoncedeLeonAvenue#106 SanJuan,Puerto Rico 00918	Puerto Rico (Phoenix Telecom)	Lease of 1999 Jeep Cherokee, VIN 537389, dated 8/30/99. Agreement provides for 55 payments of $429 per month, commencing on 9/1/99. Residual is $4,000	PL
Premium Waters, Inc. 2244 S. Calhoun Road New Berlin, WI 53151	Waukesha, WI (Americom, Inc.)	Service agreement for bottled water equipment and supplies. Agreement appears to be month to month	PL
Public Communications Services	Cary, NC	Pay Telephone Installation & Service Contract dated 01/29/98	PL
Public Storage 3150 S. 44th Street Kansas City, KS 66106	Kansas	Lease for Storage Space No. 46, between ETS Payphones and Public Storage in Kansas City, Kansas	PL

Public Storage Inc. 6609 State Road 54 New Port Richey, FL 34653-6041	New Port Richey, FL	Business complex lease dated February 24, 1999, commencing February 24, 1999 expiring February 28, 2000, lease covers property located at 6617 State Road 54, New Port Richey, FL 34653; monthly rent $599.96	SC/EQ
Public Storage Inc., 6609 State Road 54 New Port Richey, FL 34653-6041	New Port Richey, FL	Rental Agreement No.497-25436FL with Public Storage Inc. dated 2/16/00 for Storage Unit 4701. The term of the lease was month to month	ST
Public Storage, Inc. 6609 State Road 54 New Port Richey, FL 34653-6041	New Port Richey, FL	Rental Agreement between Public Storage, Inc., 701 Western Avenue, Glendale, CA 91201 and ETS Payphones – Anthony Bryan for Space No. 6513 located at 6609 State Road 54, New Port Richey, FL 34653-6014. Term of contract is month-to-month, $10 per month real tax dated 2/23/99	RL
Public Storage, Inc. 6609 State Road 54 New Port Richey, FL 34653-6041	New Port Richey, FL	Self-purchase addendum to Lease/Rental Agreement for Storage Unit 4702 dated 2/23/1999 between ETS Payphones and Public Storage, Inc	RL
Public Storage, Inc. 6609 State Road 54 New Port Richey, FL. 34603-5014	New Port Richey, FL	Rental Agreement between ETS Payphones, Inc. and Public Storage, Inc for Space No. 4709. Term of contract is month-to-month. Contract No. is 497-25436FL is dated 2/16/2000. $106 per month tax	RL
Public Storage, Inc. 701 Western Avenue Glendale, CA 91201	New Port Richey, FL	Rental Agreement dated 2/23/1999 between ETS Payphones – Anthony Brown and Public Storage, Inc. for Space No. 4702 located at 6609 State Road 54, New Port Richey, FL 34653-6014. Term of contract is month-to-month, $106 per month	RL
Q West Communications Corporation USLD Communications, Inc. 9311 San Pedro, Suite 100 San Antonio, TX 78216	Boswell, OK	Operator Services Agreement between Q West and USLD Communications and ETS Payphones dated 8/25/2000, expiration 8/25/2001	RL

Quality Control Inc. 132 W. Pine St. P.O. Box 1302 Mt. Airy, NC 27030	Siloam, NC	Pest control service agreement dated 2/19/99 for one year. Automatically renews month to month. $30 fee for quarterly service	RL
Rich Properties 1468 Carolina Ave Washington, NC 27889	Windsor, NC (Triangle)	Lease Agreement between Rich Properties and Triangle Telephone Inc., dated 6/14/96 for property located in Bernie County Industrial Park in Windsor, North Carolina used for storage, distribution and telephone repair. The term of the lease was from 6/15/96 until 12/30/96 and then month to month	SC
Santa Monica Shores, Ltd. dba West Thomas Business Center P.O. Box 25991 Los Angeles, CA 90025	Phoenix, AZ	Standard industrial/commercial multi-tenant lease-gross governing 15,075 square foot office/warehouse premises located at 3106 West Thomas Road, Suite 1119, Phoenix, AZ 85017; lease is dated May 5, 2000 and covers a three year period commencing June 1, 2000 and expiring May 31, 2003; monthly base rent for the first year is $866.00 subject to adjustment according to the consumer price index for subsequent years	RL
Schallock-Petersen Realty 21675 Doral Road Waukesha, WI 53186	Waukesha, WI (Americom, Inc.)	Lease dated August 16, 1993 and lease extension agreement dated September 15, 1999. Lease is of real property located at 2236-B and 2236-C Bluemound Road, Waukesha, WI. Lease was extended for one year and is scheduled to terminate on October 31, 2000. Rent per month $3412.34.This was an extension of two earlier leases dated 8/16/93 and 7/16/96	EA

Security Capital Industrial Trust 3453 IH 35 North San Antonio, TX 78219	San Antonio, TX (TSC NAI)	May 28, 1998 First Amendment to lease agreement with North American Intelecom, Inc. extending lease dated May 25, 1995 for an additional three year period beginning July 1, 1998 and ending June 30, 2001 for Suite 140 located at 12050 Crownpoint, San Antonio, TX; base rent $1,201.67 per month plus $303.34 in operating expenses	RL
SecurityLink from Ameritech 111 15th Avenue N. Saint Cloud, MN	Monticello, MN	Alarm services agreement dated July 8, 1999. Agreement provides for the sale and installation of monitoring equipment and the provision of security services. The contract is month to month. Monthly fee is $20	RL
SecurityLink from Ameritech 120 Interstate N. Parkway #105 Atlanta, GA	Lithia Springs	Rider to alarm services agreement dated January 31, 2000 for the purchase and installation of additional monitoring equipment. The monthly service charge is $69.00 per month	RL
SecurityLink from Ameritech 450 E. Las Olas Blvd. #12 Fort Lauderdale, FL	Fort Lauderdale	Installation and Monitoring Agreement dated 5/13/1999 between SecurityLink from Ameritech, Inc. and ETS Payphones, Inc. for a security system. The term was for three years	SC
SecurityLink from Ameritech 598 S. North Lake Blvd. #1000 Altamonte Springs, FL	Sanford, FL	Alarm Services Agreement dated 10/29/1999 for 504 Central Park, Sanford	SC
SecurityLink from Ameritech P.O. Box 9001076 Louisville, KY 40290	Lithia Springs	Alarm services agreement, dated November 29, 1999 providing for the sale and installation of security monitoring equipment and the provision of security monitoring services. The agreement is for five years beginning December 1, 1999 and continuing to November 30, 2004, with one-year optional extensions thereafter. The monthly service fee is $129.00 per month	RL

Soddy Daisy Self Storage 9218 Dayton Pike, Unit 94 Soddy Daisy, TN	Tennessee	Lease for storage facility	Non-Res
Southern California Edison	California	Security Deposit	
Storage USA 19211 Preston Rd. Dallas, TX 75252	Dallas, TX	Lease for storage space, Unit #'s 397 and 412 for $155.00 each per month	Non-Res
Super Commercial Realty Group P.O. Box 847225 Dallas, TX 75284-7225.	Corpus Christi, TX	Commercial lease with Ivan Halaj Properties dated 10/1/1999 for 1,800 square foot space located at 5233 Interstate Highway #37, Suite C-05, Corpus Christi, TX 78408 for two years commending on 10/1/99; rental payments are $910.55 per month during the first year and $955.50 per month during the second year. Property acquired by Super Commercial Realty Group in 2000	SC
T&G 18 Bergen Street Brooklyn, NY 11201	Brooklyn (City Public)	Copier Rental Agreement with ETS Payphones, Inc. dated December 28, 1999 for 36 months at $319 per month for Panasonic D350 digital copier system	SC
T&G Industries, Inc. 18 Bergen Street Brooklyn, NY 11201	Brooklyn (City Public)	All inclusive service copier contract with ETS Payphones, Inc. dated December 28, 1999 for 3 years or 300,000 copies. Automatically renews at current annual rate. Copier located at 555 63rd St., Brooklyn.	EQ
T&G 18 Bergan St. Brooklyn, NY 11201	Brooklyn, NY	Lease No. 1899170 of a copier, dated December 28, 1999. Lease is for 36 months beginning January 1, 2000 and lease payments are $319.00 per month	SC
Texas Waste Systems, Inc. P.O. Box 200404 San Antonio, TX 78220	San Antonio, TX	Service Agreement for Nonhazardous Waste between Texas Waste Systems, Inc. and ETS Payphones dated 2/10/2000, effective 2/11/2000, for 3 years and renews for 3 year terms. $47 per month plus $30 for extra pick-up	RL

The Roberts Group, Inc. P.O. Box 312 Huntsville, Al 35804	Knoxville, TN	Lease Agreement between the Roberts Group, Inc. and ETS Payphones, Inc. dated 4/7/2000 for a water cooler serial no. 00121300 made by SunRock, Model No. R&R. The term was for one year from the date of installation and then from month to month. $8.50 monthly fee	RL
Toshiba America Information Systems, inc Attn: Toshiba Easy Lease 4165 Thousand Oaks Blvd Suite 145 Westlake Village, CA 91362	New York, NY	Lease agreement with Hillicorn Service Co. for telephone switching equipment dated 5/23/1995. Term is a 60 months at $398 per month	RL
Waste Management Incorporated 345 Smith Road Mt. Airy, NC 27030	Siloam, NC	Waste management agreement	RL
Waste Management of New York, LLC 101 Varick Avenue Brooklyn, NY 11237	Brooklyn, NY (City Public)	Contract for the removal of nonhazardous trade waste beginning March 2, 2000 for 24 months with NY Public Telephone located at 555 63rd St., Brooklyn, NY 11220. Flat fee is $528.26 per month.	SC
Watch Omega Holdings, LP c/o GE Capital Realty Group, Inc. 16479 Dallas Parkway Suite 400 Dallas, TX 75248-2661	Richardson, TX (TSC Communications Corp.)	Industrial complex lease (Texas) dated February 12, 1998 governing 10,080 square foot facility located at 959 East Collins, Suite 150, Richardson, TX 75081, lease commences May 1, 1998 and runs for five years, expiring February 28, 2003; rent is $1,624.67 for the 2000 lease year	EQ
Westwind Storage 2515 Arlington Drive Colorado Springs, CO	Colorado	Lease Addendum for Unit No. 904 between Westwind Storage and ETS Pay Phones Corp, dated 12/20/99. Monthly rent is $71.	RL
Wiley & Associates	Florida	Security Deposit	

Windsor Storage 116 Country Club Lane Windsor, NC 27983	Windsor, NC	Lease for storage space	Non-Res
Wright Express Corporation	IL	Deposit on account	
Xerox Corporation P.O. Box 660501 Dallas, TX 75266-0501	Puerto Rico (Phoenix Telecom)	Copier lease dated June 1, 2000, and the agreement has an annual base charge of $285.27. Term is from 5/2/2000 to 5/30/2001.	SC

Account #	Account Name	Payee Name	Address	Address1	City	State	Zip
132	PAT SWINDALL	PAT SWINDALL	543 MONTEAGLE TRACE		STONE MOUNTAIN	GA	30087
134	COCOA EXPO	COCOA EXPO	500 FRIDAY ROAD		COCOA	FL	32926-0333
105	PROGRESSIVE MANAGEMENT	PROGRESSIVE MANAGEMENT	5633 N. 9TH AVE.		PENSACOLA	FL	32504-9300
106	AGOSTINO OIL CO.	AGOSTINO OIL CO.	22714 KESWICK STREET		WEST HILLS	CA	91304-3000
107	ARBYS	ARBYS	2201 SOUTHERN		VALLEJO	CA	94590-0000
108	THE NEW PIPER AIRCRAFT	THE NEW PIPER AIRCRAFT	2926 PIPER DRIVE		VERO BEACH	FL	32960-0000
109	GLOBE FACILITY SERVICES	GLOBE FACILITY SERVICES	FOR CITY OF CLEARWATER	500 CLEVELAND STREET	CLEARWATER	FL	33755
110	BETTY CHAPPLE	BETTY CHAPPLE	P. O. BOX 877		WINALESA	FL	32696
112	C & L FOODS, INC	C & L FOODS, INC	674 JONES LANE		DUBLIN	TX	76401
113	CAROLINA RESTAURANT GROUP	CAROLINA RESTAURANT GROUP	6040 ARROW RIDGE BLVD #1		CHARLOTTE	TX	28273-0000
114	CHINA CAFETERIA	CHINA CAFETERIA	P.O BOX 723536		ATLANTA	TX	31139
116	CLAUDE AUBOUD	CLAUDE AUBOUD	RE 10 QUAIL OAKS DR.		GRANITE BAY	CA	95746
117	COX ENTERPRISES, INC	COX ENTERPRISES, INC	1400 LAKEHEAM DRIVE		ATLANTA	TX	30319
118	DAVIS COMMUNICATION CONSULTANTS	DAVIS COMMUNICATION CONSULTANT	604 SAGEWOOD CT		WOODSTOCK	NY	30189
119	FAST MART, INC	FAST MART, INC	4564 KETTERING DRIVE		ROSWELL	GA	30075-0000
120	FATIMA INVESTMENTS, INC	FATIMA INVESTMENTS, INC	2620 LAVISTA ROAD		DECATUR	TX	30033
121	FLORIN & 24TH UNICOL	FLORIN & 24TH UNICOL	2300 FLORIN RD		SACRAMENTO	CA	95822
122	GADDIS PROPERTIES	GADDIS PROPERTIES	3245 AUSTELL RD. A1		MARIETTA	GA	30060
123	GAINESVILLE HOUSING AUTHORITY	GAINESVILLE HOUSING AUTHORITY	P. O. BOX 653		GAINESVILLE	GA	30503-0993
125	DAYTONA INTL SPEEDWAY	DAYTONA INTL SPEEDWAY	ATTN: DAVID HICKMAN	1801 W INTL SPEEDWAY BLVD	DAYTONA BEACH	FL	32114-1243
126	GOLDEN ACORN PROPERTIES	GOLDEN ACORN PROPERTIES	15 MCCOLLUM VILLAGE		NEWNAN	GA	30265
127	GOLDEN TRIANGLE REALTY, INC	GOLDEN TRIANGLE REALTY INC.	6455 N. WICKHAM RD. #C106		MELBOURNE	FL	32940
128	HAPPY STORES, INC	HAPPY STORES, INC	P. O. BOX 9		DESTIN	FL	32548
130	HOWELL OIL CORPORATION	HOWELL OIL CORP	4967 N. HENRY BOULEVARD		STOCKBRIDGE	WI	53281-0300
131	HUDULL HOUSE, INC	HUDULL HOUSE, INC	2960 EAST PONCE DE LEON AVE		DECATUR	TX	30030
132	J. COPELAND ENTERPRISES	J COPELAND ENTERPRISES	510 SPRING STREET		ATLANTA	TX	30309
133	J. C. MARKETS, INC	J C. MARKETS, INC	7008 N. WEST		FRESNO	CA	93650
134	J.D INVESTMENTS	J.D INVESTMENTS	2575 E. BELMONT		FRESNO	CA	93650
135	JOHN KEHROTIS	JOHN KEHROTIS	100 SARATOGA AVE. #200		SANTA CLARA	CA	95051-0000
139	MADISON AT THE PORT	MADISON AT THE PORT	ATTN: ACCOUNTING	3201 ASTRONAUT BLVD	CAPE CANAVERAL	FL	32920
139	K I C	K I C	3856 N. ATLANTIC AVE		COCOA BEACH	FL	32931
140	LABOR READY	LABOR READY	3804 MAIN ST.		COLLEGE PARK	MD	33337
141	LABOR WORLD	LABOR WORLD	1030-5 WINDY HILL RD		SMYRNA	TN	30080
142	WYNDHAM RESORT	WYNDHAM RESORT	1661 BISCAYNE BLVD		MIAMI	OK	33132
143	MARTINS RESTAURANT	MARTINS RESTAURANT	5727 FLOYD ROAD		MARIETTA	GA	30126
144	MCCORLEW REALTY	MCCORLEW REALTY	2326 SOUTH LUMPKIN RD.		COLUMBUS	WI	31902
145	WYNDHAM RESORT & SPA	WYNDHAM RESORT & SPA	250 RAQUET CLUB		FORT LAUDERDALE	FL	33326
146	NEW CAPITAL DIMENSIONS	NEW CAPITAL DIMENSIONS	1500 N COLUMBIA ST		MILLEDGEVILLE	GA	31061
147	RBS & ASSOCIATES	RBS & ASSOCIATES	8200 KINGSTON PIKE		KNOXVILLE	TN	37919
149	S M CORP USA	S M CORP USA	5600 ROSWELL ROAD	SUITE 205 NORTH	ATLANTA	TX	30342-0000
150	TAMPA STADIUM	TAMPA STADIUM	4226 N DALE MABRY		TAMPA	FL	33607-0000
151	ATTN - MRS. WINNERS	ATTN - MRS. WINNERS	5905 BARFIELD ROAD SUITE		ATLANTA	TX	30328
153	PREMIER MANAGEMENT CORP	PREMIER MANAGEMENT CORP	2125 BISCAYNE BLVD	SUITE 200	MIAMI	OK	33137-0000
154	RAYMOND JAMES STADIUM	RAYMOND JAMES STADIUM	4226 N. DALE MABRY		TAMPA	FL	33607-0000
155	S. S. F. ENTERPRISES	S. S. F. ENTERPRISES	4905 N WEST AVE, #103		FRESNO	CA	93705
156	EXPRESS MART/DELCO OIL	EXPRESS MART/DELCO OIL	927 S. CLARA AVENUE		DE LAND	FL	32721
157	HOP N SAVE FOOD STORES	HOP N SAVE FOOD STORES	C/O QUALITY PETROLEUM	P O BOX 3592	LAKELAND	GA	33803-3892
158	OCEAN PROPERTIES, LTD	OCEAN PROPERTIES, LTD	1100 UNION BLVD		DELRAY BEACH	FL	33444-0333
159	CHAMOUN JALLO	CHAMOUN JALLO	P.O. BOX 6932		PALM HARBOR	FL	34684-0333
160	S. MURPHY ENTERPRISES	S. MURPHY ENTERPRISES	1439 BELLEAIR ROAD		CLEARWATER	FL	33756-8333
161	LIGHTHOUSE PLAZA PARTNERS	LIGHTHOUSE PLAZA PARTNERS	C/O W.G. LASSITER, JR.	505 S. FLAGLER DR - STE 1010	WEST PALM BEACH	FL	33401-8388
162	MOHAMMED D. KHAN	ANFAL ISLAM	2408 NORTH PINE HILL ROAD		ORLANDO	FL	32808
163	FOREST OAKS PLAZA	FOREST OAKS PLAZA	221 S. BAYLEN STREET		PENSACOLA	FL	32501-0000
164	PLAZA NORTH	PLAZA NORTH	ATTN: MATT BURNEY	221 S. BAYLEN STREET	PENSACOLA	FL	32501-0000
165	PENSACOLA EASTGATE LTD	PENSACOLA EASTGATE LTD	221 S. BAYLEN STREET		PENSACOLA	FL	32501-0000
166	UNIFI	UNIFI	P. O. BOX 665		YADKINVILLE	NC	27055
167	VILLAGE MARKET	VILLAGE MARKET	P. O. BOX 25A		NORTHWILKESBORO	NC	28659-0000
168	LEE INDUSTRIES, INC	LEE INDUSTRIES, INC	P. O. BOX 26		NEWTON	NC	28658-0000
171	J. J. GOUGE & SON OIL CO	J. J. GOUGE & SON OIL CO.	P. O. BOX 7		SPRUCE PINE	NC	28777
174	GARDEN PARK PLAZA	GARDEN PARK PLAZA	C/O W.G. LASSITER, JR	505 S. FLAGLER DR STE 1010	WEST PALM BEACH	FL	33401-0000
175	PENSACOLA INTERSTATE FAIR	PENSACOLA INTERSTATE FAIR	6655 MOBILE HWY		PENSACOLA	FL	32526-0000
176	LUCKY 97	LUCKY 97	ATTN: MOHDIOBA, HASSAN BABA	1854 NE 214TH TERRACE	NORTH MIAMI BEACH	FL	33179-1534
177	KWIK STOP III	KWIK STOP III	ATTN: HALIM DAUH	4810 NW 2ND AVENUE	MIAMI	OK	33127-0000
179	ECKERD CORPORATION	ECKERD CORPORATION	P.O. BOX 4089	ATTN: ROBERT SLOAN	CLEARWATER	FL	33758
180	AMERICAN BUSINESS CORP	AMERICAN BUSINESS CORP	4300 LAND O LAKES BLVD		LAND O LAKES	WI	34639
181	SWIMLAND	SWIMLAND	3149 W HALLANDALE BCH BLVD		HALLANDALE	FL	33009-5000
182	N & P REALTY, INC.	N & P REALTY, INC	P.O. BOX 930287		NORCROSS	GA	30093-0000
183	THE RIGHT STUFF FOOD	THE RIGHT STUFF FOOD	5871 GLENRIDGE DRIVE, STE. 110		ATLANTA	TX	30328
184	ALTERMAN PROPERTIES	ALTERMAN ENTERPRISES	2924 POWERS FERRY ROAD	SUITE 120	ATLANTA	TX	30339
186	WATKINS RETAIL GROUP	WATKINS RETAIL GROUP	4900 MCDONOUGH DRIVE SUITE A-1		NORCROSS	GA	30093-5900

187	RINZLER ENTERPRISES	RINZLER ENTERPRISES	110 E. ANDREWS DR. SUITE 211	ATLANTA	TX	30326-0000
189	J.C.E.T. LLC	J.C.E.T. LLC	2116 MONROE DR.	ATLANTA	TX	30324
191	OTTER, INC.	OTTER INC	P.O. BOX 82643	HAPEVILLE	GA	30354-2643
192	TOTE-A-POKE	TOTE-A-POKE	20195 BROADWAY	POTEAU	OK	74953-0000
193	PANTRY PAL (CHEVRON)	PANTRY PAL (CHEVRON)	P.O. BOX 931513	NORCROSS	GA	30093
193	JOCKS & JILLS	JOCKS & JILLS	1 CNN CENTER	ATLANTA	TX	30303-0000
194	M & P SHOPPING CENTERS	M & P SHOPPING CENTERS	5025 WINTERS CHAPEL ROAD	ATLANTA	TX	30360
195	JOCKS & JILLS	JOCKS & JILLS	112 10TH STREET	ATLANTA	TX	30309-0000
196	HANDY PLUS	HANDY PLUS	10475 VETERANS MEMORIAL	HOUSTON	TX	77039
198	COMCHOICE, INC. FOR SPEEDY STOP	COMCHOICE, INC. FOR SPEEDY STO	1501 FM 2673	CANYON LAKE	TX	78133
199	MILLER REALTY SERVICES	MILLER REALTY SERVICES	7094 PEACHTREE IND. BLVD. NW	NORCROSS	GA	30071
200	NELTON SYSTEMS, INC.	NELTON SYSTEMS, INC.	5751 LAKE FORREST DR. NW	ATLANTA	TX	30328-0000
201	HELLGETH ENTERPRISES, INC	HELLGETH ENTERPRISES, INC	6355 LINDBERGH DRIVE NE	ATLANTA	TX	30324-0000
202	MAHAMMAD ALI	DAHLIA'S SNACK	HWY. JCT. 33&39	INOLA	OK	74036-0000
203	KWICK STOP	KWICK STOP	P.O. BOX 218	SHAWNEE	KS	74802
204	METROTAINMENT CAFES	METROTAINMENT CAFES	1057 JUNIPER STREET	ATLANTA	TX	30303
205	SCULLEY & KALLE INC	SCULLEY & KALLE INC	3504 TARA BLVD	JONESBORO	GA	30236-0000
206	KALLE ORGANIZATION, INC	KALLE ORGANIZATION, INC	3504 TARA BLVD	JONESBORO	GA	30236
207	JENSEN,LLC DBA WOLVERINE MOTOR MART	READY MART	P.O. BOX 1820	VIAN	OK	74932-0000
208	OSI	OSI	BOX 8082	SPRING HILL	FL	34609-0000
209	NALLEY COMMERCIAL	NALLEY COMMERCIAL	BOX 1929	EASLEY	SC	29641-0000
210	JAMES RAHL & NORMAN CHAN	JAMES RAHL & NORMAN CHAN	SUITE 10, STATION SQUARE	ROCKY MOUNT	NC	27804-0000
211	OSAMA M. JALAL	OSAMA M. JALAL	700 LANE STREET	WILSON	NC	27893-0000
212	HOUSING AUTHORITY OF KINSTON	HOUSING AUTH. OF KINSTON	608 N. QUEEN ST.	KINSTON	NC	28501
213	BILL AGAPION	BILL AGAPION	625 ELM STREET	GREENSBORO	NC	27406-0000
214	LK NORMAN REST VENTURE	LK NORMAN REST VENTURE	19625 STATESVILLE RD	HUNTERSVILLE	NC	28078
215	SPECTRA CORP	SPECTRA CORP	8131 LBJ FREEWAY	DALLAS	TX	75251
216	ASSOCIATED SERVICES	ASSOCIATED SERVICES	P.O. DRAWER 1242	DANVILLE	PA	17543-0000
217	PEGGY BRITT	PEGGY BRITT	877 IRON MT ROAD	ASHEBORO	NC	27203
219	CAROLINA FAMILY REST	CAROLINA FAMILY REST	BOX 534	CONCORD	NC	28026-0000
219	CHECKERS/ STARRCHEX LLC	CHECKERS/ STARRCHEX LLC	203 TELEVISION CIRCLE	SAVANNAH	GA	31406-0000
220	U. S. MERIT, INC.	U. S. MERIT, INC.	11435 HWY. 64 E	TYLER	TX	75707-0000
221	TRITON MARKETING	TRITON MARKETING	9255 DUNWOODY PLACE	ATLANTA	TX	30350
223	WATSON OIL COMPANY	WATSON OIL COMPANY	P. O. BOX 926	MARSHALL	WI	53570-0000
225	INTERA COMMUNICATIONS	INTERA COMMUNICATIONS	9420 KOLL CENTER PKWY	PLEASANTON	TX	94566
226	HEALTH FIRST	HEALTH FIRST	1550 S. HICKORY STREET	MELBOURNE	FL	32901
227	SAN JUAN UNIFIED SCHOOL DISTRICT	SAN JUAN UNIFIED SCHOOL DISTR	5133 ENGLE RD	CARMICHAEL	CA	95608-2933
228	FITZGERALD'S CONVENIENCE CENTER	FITZGERALD'S CONVENIENCE CENT	2217 ROSWELL RD., STE. B2	MARIETTA	GA	30062
229	LANCASTER RENTALS	LANCASTER RENTALS	ATTN: JERRY LANCASTER	SULPHUR	OK	73086-0000
230	BETHUNE COOKMAN	BETHUNE COOKMAN	48 DR. MCCLOUD BETHUNE BLVD.	DAYTONA BEACH	FL	32114-0000
231	ULTIMA HOLDINGS LLC	ULTIMA HOLDINGS LLC	2255 CUMBERLAND PKWY.	ATLANTA	TX	30339
232	THE GEORGIA BAR BD CO INC	THE GEORGIA BAR BD CO INC	5555 OAKBROOK PKWY.	NORCROSS	GA	30093
233	AWFUL ARTHUR'S	AWFUL ARTHUR'S	BOX 1653	KILL DEVIL HILLS	NC	27948-0000
235	PIRATES COVE YACHT CLUB	PIRATES COVE YACHT CLUB	BOX 1937	MANTEO	NC	27954-0000
236	JHM ENTERPRISES VIVEK	JHM ENTERPRISES VIVEK	BOX 8375	GREENVILLE	NC	27834-0000
237	BALLARD TIRE & OIL	BALLARD TIRE & OIL	3500 CLAREDON BLVD	NEW BERN	NC	28562
239	ASHTON MANAGEMENT COMPANY	ASHTON MANAGEMENT COMPANY	P. O. BOX 3355	BALDWIN	MO	63022-0000
240	DESPERADO'S WESTERN MART	DESPERADO'S WESTERN MART	616 N 2ND AVENUE	SILER CITY	NC	27344
241	GANDHI ASSOCIATES	GANDHI ASSOCIATES	3767 BOYWOOD ROAD	GRAHAM	NC	27253-4330
243	WALL STREET, INC.	WALL STREET, INC.	55 HUNTWICK CT	COLUMBIA	AL	29206
244	HALPERN ENTERPRISES	HALPERN ENTERPRISES	5269 BUFORD HWY	ATLANTA	TX	30340
245	ABDEL KAREEM OMAR	ABDEL KAREEM OMAR	P.O. BOX 1521	WILSON	NC	27893-0000
246	CHUCK KING	CHUCK KING	BOX 111	LIBERTY	NC	27298-0000
248	MIKE'S FOOD STORES	MIKE'S FOOD STORES	953 US HWY 321	YORK	SC	29745-0000
249	MLW ENTERPRISES	MLW ENTERPRISES	211 CENTURY DR	GREENVILLE	NC	29607-0000
250	HOOVER FOODS, INC.	HOOVER FOODS INC	4315 WETHERBURN WAY	NORCROSS	GA	30092
251	PRECISION TUNE	PRECISION TUNE	106 WOODWINDS CT	CARY	NC	27511-0000
252	HOLMES ENTERPRISES	HOLMES ENTERPRISES	P.O. BOX 620	CLINTON	NC	28328-0000
253	LEWIS A. MENG, JR	LEWIS A. MENG, JR	SUPER SPEEDWASH LAUNDRY	SALISBURY	NC	28147-0000
254	WALKER HOLDINGS GRP., LLC	WALKER HOLDINGS GRP., LLC	POST OFFICE BOX 780	ENGLEBOROUGH	NC	27278-0000
255	WINGS #2	WINGS #2	3869 HWY 127	WALLACE	NC	28466-0000
257	BETTY'S #2	BETTY'S #2	RT 1 BOX 231 HWY W	WILSON	NC	27893-0000
258	BYRD'S WHOLESALE	BYRD'S WHOLESALE	1239 E MARKET ST	SMITHFIELD	NC	27577-0000
260	HANDY STOP	HANDY STOP	BOX 275	TAYLORSVILLE	NC	28681
261	WINGS	WINGS	887 N. LAKE PARK	CAROLINA BEACH	NC	28428-0000
263	NORFOLK HOUSING AUTHORITY	NORFOLK HOUSING AUTHORITY	BOX 968	NORFOLK	VA	23501-0000
264	MILES FOOD MARKET	MILES FOOD MARKET	RTE 5, BOX 343	LYNCHBURG	VA	24502
266	INTEGRATED MGMT CORP	INTEGRATED MGMT CORP	40 NE 7TH AVENUE	DELRAY BEACH	FL	33483-0000
268	JDG, INC. OF EASLEY	JDG, INC. OF EASLEY	1501 EAST MAIN STREET	EASLEY	SC	29640-0000
267	LARRY JENKINS	LARRY JENKINS	P.O. BOX 165	CHESNEE	SC	29323-0000
269	HAWKS BBQ	HAWKS BBQ	2005 CHAMBERLAYNE AVE.	RICHMOND	VA	23222-0000
274	GRIT DBA MCDONALD'S	GRIT DBA MCDONALD'S	P.O. BOX 3036	SANFORD	TX	27330

47099	ELKS LODGE #948 #1948	13301 SW 72ST.		MIAMI	OK	33173-
47100	ISLAND VIEW	Star Rt Box 4		Carrabelle	FL	32322-
47103	ELSIES RESTAURANT	180 HIGHLAND ST.		MOUNT DORA	FL	32757
47105	EMD ASSOCIATES LIMITED	C/O SHANE SUCHMAN REALTY	1550 MADRUGA AVE #230	CORAL GABLES	FL	33146
47106	EMERALD POINT	2871 W. PIONEER		IRVING	TX	75061-
47107	ENGLEWOOD TIRE CO	2533 S MCCALL RD		ENGLEWOOD	TN	37329-
47109	ENIGMA SUPERETTE	PO BOX 134		ENIGMA	GA	31749
47110	ENNIS FOOD MART	3203 N. KAUFMAN		ENNIS	TX	75119-
47113	Entrada Pre Campana	P.O. Box 2641		Juncos	PR	777
47115	ERIC WALKER	2594 NW 46TH STREET		MIAMI	OK	33142
47119	ERILYN GROUP	4700 N. STATE RD. 7	SUITE 101	LAUDERDALE LAKE	FL	33319
47118	ERNIE'S TRANSMISSION SERV	282 WALKER ST. SW		ATLANTA	TX	30303-
47121	Escos	2640 Tift		Tifton	GA	31794
47124	ESCUELA ESTUDIANTIL	126 CALLE ROSA JARDINES		VEGA BAJA	PR	936
47125	Escuela Super Petra Corre	Apartado 30160 Suite 335		Manati	PR	674
47126	ESKO PROPERTIES	305 ROYAL PONCIANA PLAZA		PALM BEACH	FL	33480-
47128	ESSO SERVICE CENTRO M ORT	AVE COSTO PEREZ K-19 HO		SAN GERMAN	PR	00683-
47130	Estacion Servicio Roman	Carr 111 KM 1.5		Lares	PR	00669-
47131	ESTACION SERVICIO ROMAN G	PCS BOX 2768		SAN SEBASTIAN	PR	685
47132	ESTEVES GULF GAS STATION	CALLE BRAZIL B-14	GARDENVILLE	GUAYNABO	PR	901
47133	ET BBQ & LIQUOR STORE	P.O. BOX 8120		HUMACAO	PR	792
47134	EUCLID AVE YACHT CLUB	1136 EUCLID AVE		ATLANTA	TX	30307
47135	EUGENIOS CAFE	3464 SW 22ND STREET		MIAMI	OK	33145
47138	Eve Spreaman	4080 E LANCASTER		FORT WORTH	TX	76103
47142	EXPRESS WAY GROCERY	2300 ALABAMA ST		SHREVEPORT	LA	71109-
47143	EXPRESSOS DELI & FETERY	2879 S CONGRESS		DELRAY BEACH	FL	33445-
47144	EXPRESSWAY GROCERY	2309 ALABAMA ST		SHREVEPORT	LA	71109-
47147	EXXON NEW SMYRNA	726 N DIXIE FREEWAY		NEW SMYRNA BEACH	FL	32168
47146	Exxon Shop Sanderson	P.O. Box 387		Marianna	FL	32063-
47149	EXXON STATION	1140 SOUTH 4TH STREET		FORT PIERCE	FL	34950
47153	F. A. SIMS OIL COMPANY	P.O. BOX 345		LAWRENSEVILLE	GA	30045
47154	F. L. BROWN	706 SW MARTIN LUTHER KING AVE		OCALA	FL	34474
47155	FABRICS FOR LESS	19954 NW 2ND AVE.		MIAMI	OK	33169
47157	Fairfax Apts	8201 Bordeaux Ave		Dallas	TX	75209
47158	Fairfield Inn	8342 Jamaican Court		Orlando	FL	32819-
47156	FAIRHAVEN CERAMICS	3101 NW 17TH AVE		MIAMI	OK	33142
47160	FAIROZ INVESTMENTS	4100 W OAKLAND PARK BLVD		FT LAUDERDALE	FL	33313
47164	FAMILY BARBER SHOP	8142 OAK ST		NEW ORLEANS	LA	70118-
47166	FAMILY COIN LAUNDRY	1453 NW 17TH AVENUE		MIAMI	OK	33125-
47167	FAMILY COIN LAUNDRY	116 SW 18TH AVE		MIAMI	OK	33135
47172	FAMILY FOOD	2790 MONTPELIER AVE		MACON	GA	31204-
47173	FAMILY FUN CENTER	LUIS GORDAN	4510 NW 2ND AVE	MIAMI	OK	33127
47174	FAMILY GOLF RANGE INC	7151 BED BUG LAKE RD		OVIEDO	FL	32765
47175	FAMILY GROCERY ETC	900 TERRACE ST.		BATON ROUGE	LA	70802
47176	FAMILY LAUNDRY CENTER	705 BEVILLE RD		DAYTONA BEACH	FL	32119
47177	FAMILY MEDICAL CENTER	2503 NEW ORLEANS AVE		NEW ORLEANS	LA	70119
47182	FANATICS PLAZA	15443 S. TAMIAMI		FONT MYERS	FL	33908-
47193	FANCY SPORTS	HC-02 BOX 13287		SAN GERMAN	PR	00683-
47184	FARAMOND MICHEL	655 SW 27TH AVE		DANIA	FL	33312
47185	Farmacia del Pueblo	Calle Baldorioty #98		Manati	PR	687
47186	FARMACIA DEL PUEBLO	CALLE VILLA #341		PONCE	PR	00731-
47187	FARMACIA GARROCHALES	P.O. BOX 542		GARROCHALES	PR	652
47188	FARMACIA KARY MAR	BOX 5076		AGUADILLA	PR	00603-
47189	FARMACIA LA CARIDAD	HC 01 BUZON 4004		FLORIDA	PR	650
47190	FARMACIA LESMARIE	AVE. GREGORIO LEDESMA	HP-21 29th SECC	LEVITTOWN	NY	949
47191	FARMACIA VILLA REAL	CALLE #2 C-2 URB VILLA REAL		VEGA BAJA	PR	693
47196	FASHION PLUS	2103 CATON ST		NEW ORLEANS	LA	70122
47195	FASPAS	PO BOX 1287		HAWTHORNE	NJ	07507
47200	FAST & FRIENDLY INC	227 NW 54th STREET		MIAMI	OK	33150
47201	Fast Fetch	PO Box 1700		Bradenton	FL	34206-
47202	FAST FETCH GAS & FOOD	201 W. DEARBORN		ENGLEWOOD	TN	34223
47203	FAST FOOD ENTERPRISE	144 VISTA ROYAL SQUARE		VERO BEACH	FL	32962-
47204	FAST FOOD ENTERPRISES	144 VISTA ROYAL SQUARE		VERO BEACH	FL	32967-
47205	FAST FOOD ENTERPRISES	144 VISTA ROYALE SQUARE		VERO BEACH	FL	32962
47206	FAST FOOD ENTERPRISES	144 VISTA ROYALE SQ		VERO BEACH	FL	32962
47208	FAST STOP CONVENIENCE	3274 S MILITARY TRAIL		LAKE WORTH	TX	33463
47209	FAST STOP FOUR	24357 HWY 48		SORRENTO	FL	32776-
47210	FASTER FOODSTORE	1801 NW 66TH AVE		HOLLYWOOD	CA	33024
47211	FAT BOYS BARBEQUE	255 NORTH US HWY 27		SOUTH BAY	FL	33493
47213	Fat Cats	2303 Oleona Ave		Jacksonville	AL	32206
47214	Fat Freddie's Bar-B-Que	3724 Hamilton Road		Columbus	WI	31904
47216	FAT TUESDAYS	PO BOX 685167		AUSTIN	TX	78768-5197

(14)

Supreme Court, U.S.
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JUN 26 2003
OFFICE OF THE CLERK

No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

JOINT APPENDIX
(VOLUME I)

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PETITION FOR WRIT OF CERTIORARI FILED: Feb. 13, 2003
CERTIORARI GRANTED: Apr. 21, 2003

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UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-10107-DD

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

ETS PAYPHONES, INC., DEFENDANT
CHARLES E. EDWARDS, DEFENDANT-APPELLANT

DOCKET ENTRIES

DATE	DOCKET ENTRY
12/27/2000	Fee Paid by Appellant Charles E. Edwards
	* * * * *
08/28/2001	Brief of Appellant Charles E. Edwards Filed
	* * * * *

DATE	DOCKET ENTRY
10/12/2001	Brief of Appellee Securities and Exchange Commission Filed
	* * * * *
10/29/2001	Reply Brief Filed (Corrected Reply Brief Filed 11/05/01)
	* * * * *
08/06/2002	Opinion Issued
08/06/2002	Judgment Entered
	* * * * *
09/20/2002	Appellee Securities and Exchange Commission's Petition for Rehearing and Rehearing En Banc Filed
	* * * * *
11/15/2002	Petition for Rehearing and Rehearing En Banc Denied
	* * * * *

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA

No. 00-CV-2532

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES, INC., DEFENDANT
AND CHARLES E. EDWARDS, DEFENDANT

DOCKET ENTRIES

DATE	DOCKET NUMBER	DOCKET ENTRY
9/29/00	1	Complaint for injunctive and other relief
		* * * * *
9/29/00	3	Emergency motion by plaintiff for asset freeze, preliminary injunction and other equitable relief with brief in support

DATE	DOCKET NUMBER	DOCKET ENTRY
		* * * * *
10/11/00	11	Opposition by defendant Charles E. Edwards to motion for asset freeze, preliminary injunction and other equitable relief
		* * * * *
10/24/00	20	Answer by defendant Charles E. Edwards to complaint
		* * * * *
11/20/00	30	Order by Judge Jack T. Camp granting motion for asset freeze, preliminary injunction and other equitable relief
11/20/00	31	Preliminary injunction order by Judge Jack T. Camp [Entry date 11/22/00]
		* * * * *

DATE	DOCKET NUMBER	DOCKET ENTRY
		* * * * *
12/27/00	49	Notice of appeal by defendant
		* * * * *
1/3/01	53	Amended notice of appeal by defendant
		* * * * *
1/10/02	157	Consent to Final Judgment of Permanent Injunction as to defendant ETS Payphones, Inc.
		* * * * *

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. 1:00-CV-2532

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES, INC. AND CHARLES E. EDWARDS,
DEFENDANTS

COMPLAINT FOR INJUNCTIVE AND OTHER RELIEF

It appears to Plaintiff, Securities and Exchange Commission ("Commission" or "SEC"), and it alleges that:

OVERVIEW OF DEFENDANTS' SCHEME

1. This matter involves a fraudulent and unregistered offering of securities by ETS Payphones, Inc. ("ETS") and its chief executive officer, Charles E. Edwards ("Edwards") in violation of the registration and antifraud provisions of the federal securities laws. The scheme is based upon purported investments in customer-owned coin-operated telephones, and has raised approximately $300 million from more than 10,000 investors. ETS offers and sells pay telephones with leaseback contracts. Investments are offered and sold in units involving a telephone, site lease, lease/back agreement and buy/back agreement. The investments constitute investment contracts and therefore are securities. The investment program has operated as a

Ponzi scheme, i.e. a scheme whereby returns are paid to investors from monies contributed by later investors.

2. No registration statement has ever been filed in connection with the securities.

3. Selling materials issued to investors state that pay phones are a profitable business. Edwards has represented to investors that ETS is profitable. In fact, ETS is operating in the manner of a Ponzi scheme and is incurring significant net losses from payphone operations.

4. ETS is dependent on the sale of new payphone investments in order to meet its current financial obligations, such as investor lease payments and refunds.

5. An ETS disclosure document given to investors grants the investor the right to sell their payphone back to ETS for the original purchase price. However, ETS does not have the financial resources to purchase the phones if a significant number of investors request refunds.

6. Based on the foregoing, the Commission is seeking an order prohibiting the destruction of documents, preliminary and permanent injunctions, accountings, disgorgement together with prejudgment interest, and civil penalties against ETS and Edwards and an asset freeze as to Edwards, based on violations of Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933 ("Securities Act"), [15 U.S.C. 77e(a), 77e(c) and 77q(a)] and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78j(b)] and Rule 10b-5 [17 C.F.R. 240.10b-5] thereunder.

JURISDICTION AND VENUE

7. The Commission brings this action pursuant to Sections 20(b) and 20(d) of the Securities Act [15 U.S.C. 77t(b) and 77t(d)] and Sections 21(d) and 21(e) of the Exchange Act [15 U.S.C. 78u(d) and 78u(e)] to enjoin the defendants from engaging in transactions, acts, practices and courses of business alleged in this complaint, and transactions, acts, practices, and courses of business of similar purport and object, for disgorgement or illegally obtained funds and other equitable relief, and for civil money penalties.

8. The Court has jurisdiction of this action pursuant to Sections 20(b), 20(d) and 22(a) of the Securities Act [15 U.S.C. 77t(b), 77t(d) and 77v(a)] and Sections 21(d), 21(e) and Section 27 of the Exchange Act [15 U.S.C. 78u(d), 78u(e) and 78aa].

9. The defendants, directly and indirectly, made use of the mails, and the means and instrumentalities of transportation and communication in interstate commerce, in connection with the transactions, acts, practices and courses of business alleged in the complaint.

10. Certain of the transactions, acts, practices and course of business constituting violations of the Securities Act and the Exchange Act have occurred in the Northern District of Georgia, including the solicitation of investors who reside within the Northern District of Georgia. Furthermore, defendant ETS is situated in and defendant Edwards resides within the Northern District of Georgia.

11. The defendants, unless restrained and enjoined by this Court, will continue to engage in the transactions, acts, practices and courses of business and similar purport and object.

THE DEFENDANTS

12. *ETS Payphones, Inc.* is a Georgia corporation formed in October 1994. Edwards owns ninety-nine percent of the ETS shares outstanding. ETS claims that it currently owns or operates 47,000 private payphones in 32 states. ETS's offices are located in Lithia Springs, Georgia, an Atlanta suburb. ETS filed a voluntary petition under Chapter 11 of the bankruptcy code on or about September 11, 2000.

13. *Charles E. Edwards*, age 61 and a resident of Duluth, Georgia, is the founder and chairman of ETS. ETS sales documents state that Edwards has over thirty years of experience building successful sales organizations and that he has spent the last nine years in the telecommunications industry.

FACTS

A. The ETS Investment Program

14. Beginning in or about October 1994 until on or about September 11, 2000, ETS under the direction of Edwards, offered "pay telephone" investments to the general public. Investments were offered in units, which include a pay telephone, a site location, a lease/back agreement, and a buy/back agreement.

15. Each unit was sold for $6,750. ETS received $5,250. The marketing company received the difference.

16. The investments have been sold through various means, including sales agreements with marketing companies. The marketing companies have made arrange-

ments with licensed insurance agents to market and sell the ETS payphones.

17. The marketing companies or their agents have made the sale and ETS and its subsidiary PSA, Inc. has purportedly assigned a payphone to the investor.

18. There has been as much as a three-month lag between the time an investor purchased his payphone until the time he actually was assigned the payphone.

19. ETS manages the operations of the payphones, and currently has approximately 47,000 payphones under management.

20. ETS and the marketing companies have used the mails and other jurisdictional means to market the investments.

21. ETS operates a website which contains statements such as "there are millions to be made from owning pay phones" and describe payphone ownership as "virtually recession-proof" and offering a "steady, immediate cash flow."

22. Many of the investors are elderly. Substantially all have no experience managing payphones and are dependent upon the experience and resources of ETS to obtain the promised return.

23. ETS and the marketing companies have offered three basic programs for payphone purchasers. However, the program recommended by the selling agents and the program that substantially all investors have subscribed to is called the Payphone Equipment Lease Program ("lease program").

24. Under this agreement, the investor purchased a payphone and entered into an agreement to lease the payphone back to ETS for a period of sixty months (the

investor becomes the lessor and ETS becomes the lessee of the payphone). ETS agreed to pay the investor a lease payment of $82 per month per unit over the sixty-month period. These lease payments represent a 15% annual return to the investor, and are to be paid regardless of the revenue obtained from the specific payphone owned by the investor.

25. At the end of the sixty-month period, the investor had the option of renewing the lease or selling the payphone back to ETS for a full refund of the investment amount.

26. ETS also offered a full refund within 180 days of the investor's request during the initial sixty-month period.

27. During the term of the lease, the investors can cancel their leases upon 90 days notice and take possession of their phones.

28. Investors under the lease program have no involvement in the operation of the pay telephone site.

29. ETS manages and maintains the payphones, including interior and exterior maintenance as well as coin retrieval. Title to the phone and all tax advantages purportedly remain with the investor.

30. Under the lease program, ETS has the right to move the phone from one location to another.

31. The second alternative program, which was purportedly available but hardly ever sold, was called the Internal Maintenance Program ("internal program"). Under the internal program, investors would be responsible for external maintenance, including general appearance of the telephone and of the site, as well as collection of the coins. Under this program, ETS would

manage internal telephone monitoring and determine the service needs of the telephone. ETS would be responsible for sending service technicians to make necessary repairs, and for reporting repairs and non-coin revenues (such as from credit cards or telephone cards) to the owners on a monthly basis. ETS would perform these services for a fixed monthly fee. Under this alternative the return to the investor would, at least hypothetically, vary depending on the revenues received by the assigned telephone.

32. As a third option, ETS also purported to offer to sell telephone equipment with no associated agreements. However, this option, like the internal program, was hardly ever sold.

33. The lease program units are securities. ETS has never filed a registration statement with the Commission in connection with the offer and sale of these securities. No exemption from registration is applicable.

34. At least some ETS sales package included a selling brochure and a "Basic Disclosure Document Presented by ETS Payphones, Inc." (the "disclosure document"), which was presented to investors and potential investors at Edwards's direction.

35. The selling brochure includes general information about the payphone industry and includes discussions about the "profitability" of payphones.

36. The disclosure document contains brief descriptions of the company, brief biographies of management, and descriptions of the payphone management options available to investors. It also includes copies of the "telephone equipment lease agreement" and "the option

to sell agreement" to be signed by ETS and the investor.

37. ETS also has a website on the Internet which includes three brief sections describing the business of ETS, the payphone industry generally and the "profitable opportunities" of payphones.

38. The ETS selling brochure contains statements in bold print such as "watch the profits add up" and "why are pay phones so profitable." The selling brochure also contains a table entitled "Incremental Economics of a Medium-Volume Pay Phone" which shows a positive gross margin of $164 per month.

39. On July 1, 2000, Edwards sent a document to investors which represented, among other things, that ETS was profitable. Edwards also verbally represented to investors that ETS was profitable.

40. Unaudited financial statements of ETS as of December 31, 1998, March 31, 1999 and June 30, 2000 reveal that ETS has consistently been in a precarious financial situations and that payphone operations were not profitable. At all times during the course of the scheme, Edwards was aware of the true financial condition of ETS.

41. For example, ETS financial statements prepared in accordance with generally accepted accounting principles revealed that ETS had a stockholders' deficit of $24,493,531 at March 31, 1999 and that ETS had a net loss from operations of $32,033,347 for the fifteen-month period ending March 31, 1999.

42. ETS has continued to lose money on its telephone operations, and specifically lost more than $33 million from its telephone operations during the first six months of 2000.

43. In fact, ETS has consistently been dependent on the sale of new payphones in order to meet its lease and refund obligations.

44. The financial conditions of ETS and its dependency on new investors has not been disclosed to investors.

45. In its lease agreements, ETS contracted to "buy back" the investor's payphone at any time during the first sixty months of the lease term (the "put option").

46. Pursuant to the lease agreements, the investor must notify ETS of his intention to exercise the put option and is promised a full refund of the investment within 180 days of notification.

47. Additionally, an investor can either renew the lease or receive a full refund at the end of the five-year lease term. ETS is obligated to pay the refunds.

48. If a significant number of investors were to exercise their put options or request refunds at or near the same time period, Edwards knew that ETS did not have the cash to make such payments. Edwards knew that fact but it was not disclosed to investors.

49. During the course of the scheme, Edwards has taken at least a $14 million out of ETS through loans and fees paid to companies controlled by him.

CLAIMS FOR RELIEF

COUNT I

Violations of § 17(a) of the Securities Act [15 U.S.C. § 77q(a)]

50. Paragraphs 1-49 are hereby realleged and are incorporated herein by reference.

51. From in or about October 1994 through at least September 10, 2000, defendants ETS and Edwards, in the offer and sale of securities, specifically the above-described securities, by use of the means and instruments of transportation and communication in interstate commerce or by use of the mails,

(a) directly and indirectly employed devices, schemes and artifices to defraud purchasers of such securities;

(b) directly and indirectly obtained money or property by means of untrue statements of a material fact or omissions to state a material fact necessary in order to make the statements made, not misleading; and

(c) engaged in transactions, practices and a course of business which would have operated as a fraud or deceit upon the purchasers of such securities, all as more particularly described in paragraphs 1-49 above.

52. Defendants ETS and Edwards knowingly, intentionally, and/or recklessly engaged in the aforementioned devices, schemes and artifices to defraud.

53. By reason of the foregoing, defendants ETS and Edwards have violated and, unless restrained and enjoined, will continue to violate § 17(a) of the Securities Act [15 U.S.C. § 77q(a)].

COUNT II

Violations of § 10(b) of the Exchange Act [§ 15 U.S.C. 778j(b) and Rule 10b-5 Thereunder [17 C.F.R. § 240.10b-5]

54. Paragraphs 1-49 are hereby realleged and are incorporated herein by reference.

55. From in or about October 1994 through at least September 10, 2000, defendants ETS and Edwards, by their conduct as set forth above, singly and in concert, by the use of means and instrumentalities of interstate commerce and by the use of the mails, directly and indirectly:

(a) employed devices, schemes, and artifices to defraud;

(b) made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and

(c) engaged in acts, practices and courses of business which operated as a fraud and deceit upon persons, all more particularly described in paragraphs 1-49 above.

56. Said defendants knowingly, intentionally and/or recklessly engaged in the above-described conduct.

57. The statements and representations alleged herein were known to defendants or recklessly disregarded by them to be materially false and misleading. In making the material misrepresentations of fact and material omissions described herein, defendants acted with scienter, that is, with an intent to deceive, manipulate or defraud with reckless disregard for the truth.

58. By reason of the foregoing, defendants ETS and Edwards have violated and, unless restrained and enjoined will continue to violate § 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

COUNT III

Violations of § 5(a) and 5(c) of the Securities Act [15 U.S.C. § 77e(a) and 77e(c)]

59. Paragraphs 1-49 are hereby realleged and are incorporated herein by reference.

60. From in or about October 1994 through at least September 10, 2000, defendants ETS and Edwards, directly and indirectly, singly and in concert have, and unless enjoined will continue to:

(a) make use of the means or instruments of transportation or communications in interstate commerce or of the mails to sell the securities described herein, through the use or medium of any prospectus or otherwise;

(b) carry securities or cause such securities, as described herein, to be carried through the mails or in

interstate commerce, by means or instruments of transportation, for the purpose of sale or delivery after sale; and

(c) make use of the means or instruments of transportation or communications in interstate commerce or of the mails to offer to sell through the use or medium of any prospectus or otherwise the securities described herein,

without a registration statement having been filed or being in effect with the Commission; including but not limited to, the activities described in paragraphs 1-49 above.

PRAYER FOR RELIEF

WHEREFORE, the Plaintiff Commission, respectfully prays that the Court:

I.

Make findings that each and every defendant committed violations alleged herein.

II.

§ 17(a) of the Securities Act

Issue preliminary and permanent injunctions restraining and enjoining defendants ETS and Edwards, as well as their agents, servants, employees, attorneys and all persons in active concert or participation with them, who receive actual notice of the order of injunction, by personal service or otherwise, and each of them in the offer or sale of any securities by the use of any means or instruments of transportation or com-

munication in interstate commerce or by the use of the mails, from directly or indirectly:

(a) employing any device, scheme, or artifice to defraud;

(b) obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(c) engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser of such securities.

III.

§ 10(b) of the Exchange Act and Rule 10b-5 Thereunder

Issue preliminary and permanent injunctions restraining and enjoining defendants ETS and Edwards as well as their agents, servants, employees, attorneys, and all persons in active concert or participation with them, who receive actual notice of the order of injunction, by personal service or otherwise, and each of them in connection with the purchase or sale of securities, by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, from directly or indirectly:

(a) employing any device, scheme or artifice to defraud;

(b) making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person.

IV.

§ 5(a) and 5(c) of the Securities Act

Issue preliminary and permanent injunctions restraining and enjoining defendants ETS and Edwards, as well as their agents, servants, attorneys, and all persons in active concert or participation with them, who receive actual notice of the order of injunction, by personal service, facsimile or otherwise, and each of them, by use of the mails or any means or instrumentality of interstate commerce, from directly or indirectly:

(a) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell securities, in the form or common stock or any other security, through the use or medium of any prospectus or otherwise, unless and until a registration statement is in effect with the Commission as to such securities;

(b) carrying securities, or causing them to be carried through the mails or in interstate com-

merce, by any means or instruments of transportation, for the purpose of sale or delivery after sale, unless and until a registration statement is in effect with the Commission as to such securities;

(c) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy, through the use or medium of any prospectus or otherwise, any interest in securities, in the form of common stock or any other security;

unless a registration statement is in effect with the Commission as to such securities, or while a statement filed with the Commission as to such security is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8 of the Securities Act. [15 U.S.C. 77h];

in violation of section 5 of the Securities Act. [15 U.S.C. 77e].

V.

Order Prohibiting Destruction of Documents

Orders prohibiting defendants ETS and Edwards, their agents, servants, employees, and those persons in active concert or participation with them who receive actual notice of the orders by personal service, facsimile or otherwise, and each of them, from directly or indirectly, tampering with, mutilating, altering, erasing, concealing, removing, destroying or otherwise disposing of any and all books, records, documents, files, correspondence, computer tapes, computer disks, computer diskettes or any other data recordings or any

type, however created, produced or stored, relating to, pertaining to or referring to the defendants, their officers, directors, employees and agents, or any financial transactions by either of the defendants or to which either of the defendants was a party.

VI.

Order Requiring Accounting, Freeze of Assets And Disgorgement Of Ill-Gotten Gains

Issue Orders requiring an accounting from the defendants of all funds received from the sale of securities described in this Complaint, an order freezing the assets of defendant Edwards and an order for defendants ETS (to be enforced in ETS's bankruptcy proceeding for so long as it is pending or to be enforced in this proceeding in the absence of a pending bankruptcy), and Edwards to disgorge all ill-gotten gains or unjust enrichment with prejudgment interest, to effect the remedial purposes of the federal securities laws.

VII.

Civil Money Penalties

Issue an Order setting the amount of civil penalties against defendants ETS (to be enforced in ETS's bankruptcy proceeding for so long as it is pending or to be enforced in this proceeding in the absence of a pending bankruptcy) and Edwards pursuant to § 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and § 21(d)(3) of the Exchange Act.

VIII.

Other Relief

Issue findings of fact and conclusion of law in accordance with Rule 52 of the Federal Rules of Civil Procedure, along with such other and further relief as may be just, equitable and appropriate in connection with the enforcement of the federal securities laws and for the protection of investors. Further, the Securities and Exchange Commission respectfully prays that the Court retain jurisdiction over this action in order to implement and carry out the terms of all orders and decrees that are entered or to entertain any suitable application or motion by the Commission for additional relief within the jurisdiction of this Court.

Respectfully Submitted,

/s/ WILLIAM P. HICKS
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IN THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. 1:00-CV-2532

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES, INC. AND CHARLES E. EDWARDS,
DEFENDANT

ANSWER AND DEFENSES OF DEFENDANT CHARLES E. EDWARDS

Defendant Charles E. Edwards ("Defendant") answers Plaintiff's Complaint for Injunctive and Other Relief ("Complaint") as follows:

FIRST DEFENSE

Plaintiff's Complaint fails to state a claim against Defendant upon which relief may be granted.

SECOND DEFENSE

Plaintiff's Complaint should be dismissed because this Court lacks jurisdiction over the subject matter of Plaintiff's Complaint.

THIRD DEFENSE

Plaintiff's Complaint fails to plead fraud with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure.

FOURTH DEFENSE

Defendant relied upon the advice of counsel that ETS was not engaged in the offer or sale of securities.

FIFTH DEFENSE

The relief sought in Plaintiff's Complaint is barred, at least in part, by the applicable statute of limitations and the doctrine of laches.

SIXTH DEFENSE

The equitable relief requested in Plaintiff's Complaint is barred by the doctrine of unclean hands.

SEVENTH DEFENSE

Plaintiff is barred from seeking the relief requested by the doctrine of estoppel.

EIGHTH DEFENSE

Defendant, at all times relevant to the allegations contained in the Complaint, acted in good faith and with the intent and desire to comply with the law.

NINTH DEFENSE

Defendant responds to each and every enumerated paragraph of the Complaint as follows:

1.

Defendant denies the allegations contained in paragraph 1 of Plaintiff's Complaint.

2.

Defendant denies that the payphone leases were "securities" as alleged in paragraph 2 of Plaintiff's Complaint, but admits that, because no securities were involved, no registration statement was filed.

3.

Defendant denies the allegations contained in paragraph 3 of Plaintiff's Complaint.

4.

Defendant denies the allegations contained in paragraph 4 of Plaintiff's Complaint.

5.

Defendant denies the allegations contained in paragraph 5 of Plaintiff's Complaint.

6.

Defendant denies the allegations contained in paragraph 6 of Plaintiff's Complaint.

7.

Defendant is without sufficient knowledge or information to form a belief as to the truth of the allegations contained in paragraph 7.

8.

Defendant denies the allegations contained in paragraph 8 of Plaintiff's Complaint.

9.

Defendant denies the allegations contained in paragraph 9 of Plaintiff's Complaint.

10.

Defendant denies the allegations contained in paragraph 10 of Plaintiff's Complaint.

11.

Defendant denies the allegations contained in paragraph 11 of Plaintiff's Complaint.

12.

Defendant admits the allegations contained in paragraph 12 of Plaintiff's Complaint.

13.

Defendant denies that he is 61 years old and denies that ETS has "sales documents" utilized for the sale of securities, and admits the remainder of the allegations contained in paragraph 13 of Plaintiff's Complaint.

14.

Defendant denies the allegations contained in paragraph 14 of Plaintiff's Complaint.

15.

Defendant denies the allegations contained in paragraph 15 of Plaintiff's Complaint.

16.

Defendant denies the allegations contained in paragraph 16 of Plaintiff's Complaint.

17.

Defendant denies the allegations contained in paragraph 17 of Plaintiff's Complaint.

18.

Defendant admits the allegations contained in paragraph 18 of Plaintiff's Complaint, except with respect to the use of the word "investor" which implies that a security was involved, which Defendant denies.

19.

Defendant admits the allegations contained in paragraph 19 of Plaintiff's Complaint.

20.

Defendant denies the allegations contained in paragraph 20 of Plaintiff's Complaint.

21.

Defendant denies the allegations contained in paragraph 21 of Plaintiff's Complaint.

22.

Defendant denies the allegations contained in paragraph 22 of Plaintiff's Complaint.

23.

Defendant is without knowledge or information sufficient to either admit or deny what any "marketing companies" or "selling agents" may have done, and admits the remaining allegations contained in paragraph 23 of Plaintiff's Complaint, except with respect to the use of the word "investor," which implies that a security was involved, which Defendant denies.

24.

Defendant denies the allegations contained in paragraph 24 of Plaintiff's Complaint, except Defendant admits that lease payments are to be paid regardless of the revenue obtained from any specific payphone.

25.

Defendant denies the allegations contained in paragraph 25 of Plaintiff's Complaint.

26.

Defendant denies the allegations contained in paragraph 26 of Plaintiff's Complaint.

27.

Defendant admits the allegations contained in paragraph 27 of Plaintiff's Complaint, except with respect to the use of the word "investor" which implies that a security was involved, which Defendant denies.

28.

Defendant admits the allegations contained in paragraph 28 of Plaintiff's Complaint, except with respect to the use of the word "investor" which implies that a security was involved, which Defendant denies.

29.

Defendant admits the allegations contained in the first sentence of paragraph 29 of Plaintiff's Complaint and denies the remaining allegations of that paragraph.

30.

Defendant admits the allegations contained in paragraph 30 of Plaintiff's Complaint.

31.

Defendant denies the allegations in the first, second, and sixth sentences of paragraph 31 of Plaintiff's Complaint and admits the allegations in the third, fourth, and fifth sentences of paragraph 31 of Plaintiff's Complaint.

32.

Defendant denies the allegations contained in paragraph 32 of Plaintiff's Complaint.

33.

Defendant denies the allegations contained in paragraph 33 of Plaintiff's Complaint.

34.

Defendant denies the allegations contained in paragraph 34 of Plaintiff's Complaint.

35.

Defendant denies the allegations contained in paragraph 35 of Plaintiff's Complaint.

36.

Defendant admits that the "Basic Disclosure Document Presented by ETS Payphones, Inc." contains the matters set forth in paragraph 36 of Plaintiff's Complaint and denies any remaining allegations.

37.

Defendant denies the allegations contained in paragraph 37 of Plaintiff's Complaint.

38.

Defendant is without sufficient knowledge or information to form a belief as to the truth of the allegations contained in paragraph 38.

39.

Defendant denies the allegations contained in paragraph 39 of Plaintiff's Complaint.

40.

Defendant denies the allegations contained in paragraph 40 of Plaintiff's Complaint.

41.

The document speaks for itself. Defendant otherwise denies the allegations contained in paragraph 41 of Plaintiff's Complaint.

42.

Defendant denies the allegations contained in paragraph 42 of Plaintiff's Complaint.

43.

Defendant denies the allegations contained in paragraph 43 of Plaintiff's Complaint.

44.

Defendant denies the allegations contained in paragraph 44 of Plaintiff's Complaint.

45.

Defendant denies the allegations contained in paragraph 45 of Plaintiff's Complaint.

46.

Defendant denies the allegations contained in paragraph 46 of Plaintiff's Complaint.

47.

Defendant denies the allegations contained in paragraph 47 of Plaintiff's Complaint.

48.

Defendant denies the allegations contained in paragraph 48 of Plaintiff's Complaint.

49.

Defendant denies the allegations contained in paragraph 49 of Plaintiff's Complaint.

COUNT I

50.

Defendant incorporates by reference his above responses to the allegations contained in paragraphs 1-49 of the Plaintiff's Complaint.

51.

Defendant denies the allegations contained in paragraph 51 of Plaintiff's Complaint.

52.

Defendant denies the allegations contained in paragraph 52 of Plaintiff's Complaint.

53.

Defendant denies the allegations contained in paragraph 53 of Plaintiff's Complaint.

COUNT II

54.

Defendant incorporates by reference his above responses to the allegations contained in paragraphs 1-49 of the Plaintiff's Complaint.

55.

Defendant denies the allegations contained in paragraph 55 of Plaintiff's Complaint.

56.

Defendant denies the allegations contained in paragraph 56 of Plaintiff's Complaint.

57.

Defendant denies the allegations contained in paragraph 57 of Plaintiff's Complaint.

58.

Defendant denies the allegations contained in paragraph 58 of Plaintiff's Complaint.

COUNT III

59.

Defendant incorporates by reference his above responses to the allegations contained in paragraphs 1-49 of the Plaintiff's Complaint.

60.

Defendant denies the allegations contained in paragraph 60 of Plaintiff's Complaint.

PRAYER FOR RELIEF

Defendant denies that Plaintiff is entitled to any of the relief sought in paragraphs numbered I, II, III, IV, V, VI, VII, or VIII.

DEMAND FOR JURY TRIAL

Defendant demands a trial by jury for all matters triable by jury.

WHEREFORE, Defendant Charles E. Edwards, having fully answered Plaintiff's Complaint, respectfully requests judgment be rendered in his favor as to all allegations of the Complaint and that he be awarded attorneys fees and other costs and expenses, as well as such other and further relief as this Court deems just and appropriate. Defendant reserves the right to assert additional defenses as discovery progresses in this action.

Respectfully submitted,

KUTAK ROCK LLP

By: /s/ MICHAEL K. WOLENSKY
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Attorneys for Defendant
Charles E. Edwards

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. 1:00-CV-2532-JTC

SECURITIES AND EXCHANGE COMMISSION

v.

ETS PAYPHONES, INC.; CHARLES E. EDWARDS,
DEFENDANT

TRANSCRIPT OF PRELIMINARY INJUNCTION
PROCEEDINGS BEFORE THE HONORABLE
JACK T. CAMP UNITED STATES DISTRICT JUDGE

APPEARANCES:

FOR THE PLAINTIFF:

WILLIAM P. HICKS
EDWARD GARY SULLIVAN
SUSAN SHERRILL
ATTORNEYS AT LAW

FOR THE DEFENDANT EDWARDS:

MICHAEL K. WOLENSKY
ANGELA B. MIELE
ETHAN H. COHEN
ATTORNEYS AT LAW

FOR THE DEFENDANT ETS:

SCOTT SORRELS
SHARON NAGLE
ATTORNEYS AT LAW

* * * * *

[15]

OPENING STATEMENT

BY MR. WOLENSKY.

* * * * *

[17]

Now, there is no allegation here of misappropriation from this company. The SEC says companies controlled by Mr. Edwards got some loans from the debtors. Companies—

THE COURT: Interest free loans, I think was the allegation.

MR. WOLENSKY: I'm sorry?

THE COURT: I believe interest free loans was the allegation.

MR. WOLENSKY: Interest free loans. Mr. Edwards owns all of these companies 100 percent, although there is a dispute about somebody owning a portion of ETS. And that matter is in litigation. But he is the 100 percent shareholder, virtually 100 percent shareholder of all of these companies. And these interest free loans, for the most part, you will hear testimony about that, went to one entity called Twin Leaf, which is a management and holding company, and it has certain subsidiaries that provides support services to the ETS companies. And you will hear how those loans were used. But there is certainly no allegation of misappropriation. Everything is on the books and records of the company. There is no allegation of a secret taking of funds. There is no allegation of looting. There is no allegation of extravagant lifestyles. Everything Mr. Edwards owns is either real

estate or in his businesses. He doesn't even have a brokerage account.

* * * * *

[29]

DAVID CRUMPTON

PLAINTIFF'S WITNESS

SWORN

DIRECT EXAMINATION

BY MR. HICKS:

* * * * *

[31]

Q. Judge, I tender Mr. Crumpton as an expert on the financial viability of companies, the general and financial statements of ETS.

* * * * *

[36]

MR. WOLENSKY: Your honor, I would submit, in light of the defendant's lack of training in the area, the lack of authoritative support for the opinions, and the lack of peer review, that expert testimony under the kwomo tire test is not available for this witness, and we would urge the court not to consider him an expert and not accept his testimony.

THE COURT: Mr. Hicks?

MR. HICKS: Judge, I would point out he has had 30 years of doing nothing but this essentially, and I think that makes him, with all his training, makes him more than a sufficient expert to evaluate a set of financial statements.

THE COURT: I am going to overrule your objection, Mr. Wolensky. I think the witness is well-qualified to review the finances and financial statements of the company, and offer his opinion as to whether they are viable in the sense that he defines viability, and has done that over the years. All right.

* * * * *

[39]

Q. What were the totals related to the payphone operations for 1999 and for six months of 2000?

A. For this 18–month period combined, the company had operating revenues from calling operations of about $76 million. The telephone calling operations expenses for this same period was approximately $74 million, which is about 96 percent of revenue.

The company had lease payments to investors during this 18–month period of $52 million, which is about 68 percent of revenue, and had G & A expenses, general and administrative expenses, of about $25 million over this 18–month period which is about 33 percent of revenue. The total cost and expenses that I just listed amount to about $151 million, or 197 percent of the telephone calling operations revenue, thus their losses from these operations is in the range of $74- to $75 million for a negative operating loss of 97 percent of revenue.

Q. If you just isolate, for example, the first six months of the year 2000, what was the loss over that period?

A. The loss over that period was $33 million on revenue of $29 million.

Q. Now, the company also had, did it not, revenue from sales of payphones?

A. It did.

Q. And was what that revenue?

A. For the 18–month period, the company had revenue from payphone sales of approximately $177 million, the cost which I could identify as being cost and expenses associated with the payphone sales, including refunds of leases, was approximately $88 million. So the profits from the payphone sales would equate to $88- to $89 million, or about a 50 percent gross margin, if you want to think of it that way.

Q. Now, to be clear, we are not talking about GAAP or NonGAAP here; correct? We are talking about cash?

A. That is essentially correct. This is not—these are based on the internally prepared financial statements which report payphone sales revenue at the time, essentially, at the time of the transaction itself. The only noncash piece of this that I am aware of would be some relatively minor amounts of depreciation and amortization. And relatively minor, we are talking about perhaps $1- or $2 million.

Q. Now, do you have an opinion with reasonable certainly as to whether the payphone operations, without the input of additional revenues from new sales of payphones, are or have been viable at any time?

A. Certainly for this 18–month period, the payphone operations is a losing–money proposition. The revenues itself as compared to just the cost of the operations and the cost of the lease payments, ignoring G & A completely, is a substantial loss. Perhaps over the 18

months looks like perhaps $50 million loss on $76 million of revenue.

Q. Do you have an opinion with reasonable certainty as to whether ETS was dependent on sales of payphones to new investors to stay afloat?

A. Yes, they were dependent on such sales. In reviewing the company's financial statements, they really had no other significant source of cash coming in the door to stay in business.

Q. Now, is ETS insolvent?

A. Yes, it is.

Q. Can you explain why?

A. This might be an appropriate point to digress and talk about GAAP and NonGAAP. The company's internal financial statements record the sales of the payphones, and the cost and expenses of the payphone sales basically at the time of sale; therefore, they had over this 18–month period about $88 million of profits from payphone sales. Under Generally Accepted Accounting Principals, that accounting treatment is inappropriate and misleading.

Under Generally Accepted Accounting Principals the accountant's, financial accountants's standards board concluded many years ago that these are not sales transactions at all in the economic substance, even though the legal form of it is a sale and lease back. The accounting profession concluded that in fact these are really loans from the investors to the company.

* * * * *

[44]

Q. Did the financial statements indicate any funds transferred to affiliates of the company?

A. They did.

Q. Can you tell us what they reflect?

A. The balance sheet as of June 30th showed accounts receivable due from affiliates of $11.6 million, and investments in subsidiaries of $6.1 million of 6.2 for a total of $17.8 million invested in or advanced to related parties or affiliates at that date.

Q. Is that item identified on any of the financial statements in the notes?

A. The footnotes to one of the financial statements, I believe it was the March 31, 1999 financial statements, indicated that these affiliates were companies controlled by the primary shareholder of ETS, that the loans are noninterest bearing, they are due on demand, and that the affiliates themselves did not have the cash to repay the borrowings.

Q. In addition to those, did the financial statements reflect the payment of fees to affiliates?

A. The footnotes to these March 1999 financial statements indicated that there was a fee paid to one of these affiliates starting January 1, 1999 of $250 for each payphone unit sale. Previous to January 1 of 1999 that figure was $150. The amount paid to affiliates as disclosed in these financial statements for the 15–month period ended March 31, 1999 was $3.1 million. I could not separately identify these fees to affiliates in the subsequent financial statements.

MR. HICKS: I have nothing further from this witness.

THE COURT: Mr. Wolensky?

CROSS-EXAMINATION

BY MR. WOLENSKY:

Q. Mr. Crumpton, you said that the amounts of these loans and fees, those are shown in the financial statements; correct?

A. The loans and to affiliates and to investments in subsidiaries are shown on the face of the balance sheet. The fees are disclosed in the footnotes to the March 31, 1999 financial statements.

Q. And those are financial statements that you got from the SEC; Right?

A. That is correct.

Q. Do you know where the SEC got them?

A. I don't. They were compiled, however, by independent accountants, the Leventhal and Horath firm.

Q. Did you ask—well, you said you didn't ask the company for any information, so you didn't try to find out the detail about this before you testified, did you?

A. I used the documents that were available to me. I did not contact the company and have had no contact with the company.

Q. Now, you testified a few minutes ago that there is some $177 million of recently acquired, in the last 18 months of so, of payphones that were acquired that are under lease that the company has agreed to repurchase on—that's the 180–day notice; is that correct?

A. That is correct. $177 million represents the total of the payphone sales revenue for the 18–month period ended June 30, 2000.

Q. So as an accountant you say, well, they sold $177 million, and they have—or that they've got—so they have an obligation of $177 million because they may have to buy them all back? I mean, that's how you account for that?

A. That is how the accounting profession treats those kinds of transactions.

Q. Do you know what the historical liquidations—you understand that over the years they have been about 1 percent; is that correct?

A. I don't know the historical percentage.

Q. Did you ask the SEC what it was?

A. No, and it is not really relevant from the standpoint of the treatment in the financial statements as current liabilities.

Q. Is it relevant for how the company looks at its business and how much money it is going to have to have to pay liquidations to look at what the historical record has been and how many it may have to liquidate in any given year? If you were running a business, you would want to know that, wouldn't you?

A. Yes. As long as there were sufficient resources to continue in business. If there are not sufficient resources to continue in business, then the historical percentage buy-back of the payphone units would not necessarily hold up.

Q. Well, let's talk about that a minute. Now, at one point you said, in response to Mr. Hick's question, that

this company was dependent on payphone sales to new investors to stay afloat.

A. Correct.

Q. Well, you understand this company doesn't sell—ETS doesn't sell payphones to investors. You understand that, don't you?

A. I understand that they sell through distributors who resell to the investors.

Q. Don't you understand that the subsidiary PSA sells phones to distributors, and I think you gave the number of about $5300; right?

A. That is the number that was disclosed in the rescission offer to the Pennsylvania residents.

Q. Do you have any reason to doubt the accuracy of that number:

A. No.

Q. And then the distributors sells that phone or sells the phone, you said it is something like $7,000 to an individual; correct?

A. Yes. And those numbers, as I understand it, have changed over the course of the company's history. The $7,000, however, it was the number disclosed in the November of 1999 rescission offer, and would presumably be pretty current.

Q. And it's gone from $5,000 to $6,000, to $7,000. Is that what you understand?

A. Along those lines.

Q. So the sales that are made by PSA are made to distributors; correct?

A. I am not familiar with the PSA relationship. I do know that the sales are made through the distributors who resell to the investors, as I understand it.

Q. You understand that ETS doesn't sell payphones, don't you?

A. I understand that ETS is recording payphone sales revenue.

Q. ETS and subsidiaries; correct?

A. That is probably correct.

Q. Is there any reason why this company that you know of is required to maintain its internal financial statements using GAAP accounting convention?

A. Internally the company has flexibility to report as it sees fit.

Q. Is this company a public company, as far as you know?

A. Not as far as I know?

Q. It doesn't file reports with the SEC, does it?

A. Not that I am aware of.

Q. And the statements you have seen, the financial statements given you by the SEC, did the SEC advise you those were internal financial statements?

A. Yes.

Q. So if the company chooses to look at its business on a realistic basis, basically a cash basis, as Mr. Hicks called it, money in/money out, and obligations that are set up, that's up to the company to do that to guide its future business; correct?

A. The company can use the cash method if it's so chooses without violating any accounting principles insofar as disclosures, public disclosures.

* * * * *

[52]

Q. You do understand that the distributors in this are not affiliated with ETS in any way?

A. That is my understanding.

Q. Do you also understand once a payphone is purchased the payphone purchaser has the opportunity to select any management company they choose, or to manage it themselves?

A. Yes. I understand that to be an option, however, the company's disclosure in the Pennsylvania rescission indicated that most did not elect those options.

Q. Well, most, from the ones involved here, but there are many other payphones owners that have locations other than those dealing with ETS; correct?

A. Of these people? Of ETS customers? Or just generally.

Q. No. In general. It is a very large business; correct?

A. Yes. There are—right. Yeah. There are many other payphone operators.

* * * * *

[53]

Q. Do you understand that ETS has contracts with numerous well-known convenience stores, gas stations,

and companies like that to place payphones at their locations?

A. At site locations?

Q. Yes.

A. Yes, I assume that they did.

Q. Do you know they have thousands of sites out there where they have payphones and they have a large operation of people going out and collecting money and servicing phones; you understand that, correct?

A. Yes. That makes sense.

* * * * *

[57]

CHARLES EDWARDS

PLAINTIFF'S WITNESS

SWORN

DIRECT EXAMINATION

BY MR. HICKS:

A. Charles Eller Edwards.

[58]

Q. Good afternoon, Mr. Edwards. Mr. Edwards, you are, for all intents and purposes the owner of ETS; are you not?

A. Yes, sir.

Q. All right. And you are currently the chairman of the board of ETS?

A. Yes.

Q. And previously you were the CEO of ETS; correct?

A. Correct.

Q. Over what period were you the CEO?

A. Up until approximately four months ago.

Q. From when?

A. From the date we started, which was 1994.

Q. All right. There is also a company called PSA; Correct?

A. Correct.

Q. Is that a wholly-owned subsidiary of ETS?

A. Yes.

Q. What that also under your control?

A. Yes.

Q. Was PSA the entity that technically sold the telephone?

A. They wholesale the phones to the distributors. Yes, sir.

Q. Now, in your capacity as CEO, were you familiar with the sales literature that ETS used?

A. ETS only used sales literature when it went out to obtain locations to put phones. We never sold any pay phones nor did we put out any sales literature to sell payphones.

[59]

Q. Let me show you a document, a copy of which is Exhibit 17. Have you ever seen this document?

A. Yes, sir, I designed it. This was given to people like Diamond Shamrock, or The Circle K, or The Mom and Pop on the corner when we were trying to establish the right to put a phone at their location.

Q. Were you aware that the distributors were using this, a document very similar to this to sell the phones?

A. They were using a similar document that they designed. Yes. But if they were not using that document, not to my knowledge.

Q. You saw their documents also, though, didn't you, sir?

A. Yes, sir.

Q. Were you aware of the financial condition of ETS throughout your tenure as CEO?

A. Yes, sir.

Q. Were you aware, for example, of the amount of revenues coming in from payphone operations versus sales of payphones?

A. Did you hear Mr. Crumpton discuss various financial statements this morning?

Q. Yes, sir.

A. And isn't it a fact that those financial statements were provided to the SEC by ETS?

Q. Yes, sir.

A. Were you also aware that you that ETS was dependent on new investors to sustain its operation?

[60]

A. Yes, sir. As we were set up at that point, yes, sir.

Q. Were you aware that ETS did not have the resources to make good on the puts, if a substantial number of investors chose to make a put, sell the phone back?

A. No, sir, because we had payphones backing up the lease, we had the ability to take those phones to the marketplace and sell them, so we did have the ability to raise funds to, other than the sales, to liquidate the phones.

* * * * *

[62]

Q. Are you the owner of Twinleaf?

A. Yes.

Q. Are you the sole shareholder?

A. Yes.

Q. What does that company do?

A. The company is a management company, that when we saw the revenue dropping two or three years ago in the payphone industry, we chose to diversify to be able to support ETS with products and services that would generate additional revenue as we saw coming down from our payphones. It is a full aixe carrier, legend communications, which is certified to do long distance in 49 states which carries all of the long distance on our ETS phones, and all of our corporate offices. It has a company called TPL which manufactures prepaid calling cards which we sent to each of our payphone owners, a 20-minute prepaid calling card with out check every time, plus they are [63] sold to convenience stores that we have phones in. We have Twin Lead Media, which is—we have a patented—

THE COURT: Excuse me, Mr. Edwards. Tell me again what the name of the company is.

THE WITNESS: Twinleaf, Inc.

THE COURT: Twinleaf:

THE WITNESS: Yes, sir. One word.

THE COURT: Thanks. Excuse me for interrupting you. Go ahead.

THE WITNESS: We have Twinleaf Media, which is a patented kiosk for backlit illumination of advertising on our payphones, which we have contracted with a number of our major chains to put in, mainly in our convenience stores. We have a company called Axis, which is a patented 3-D advertising. We are doing all of the BP and Amoco fountain centers 5,000 stores now, plus we do advertising on the side of the payphones of 3-D imaging. We have—we did have liberty motor sports, which has since been sold that advertised ETS on the NASCAR track. I am trying to remember if I got everything.

Q. Twinleaf is not owned by ETS, is it?

A. No, sir. It was set up—it was designed to support ETS. It was set up mainly for taxes. We have been in discussion with legal and accounting over the last six months prior to this ever happening to consolidate them all in one company, but to go forward with it, because they were designed for ETS's—

[64]

Q. Has Twinleaf borrowed money in ETS?

A. Yes, sir.

Q. What is the current outstanding balance?

A. Approximately $8.1 million.

Q. Are those interest-free loans?

A. Yes, sir.

Q. Are they demand loans, in essence?

A. Correct.

Q. Have any other entities owned by you, separate from the ones in bankruptcy, borrowed money from ETS?

A. The different companies within Twinleaf – not from ETS, no, sir.

Q. Or from PSA?

A. No, sir.

Q. Have they borrowed it from any subsidiary of ETS?

A. Legends may have. I don't know that for a fact, but Legends may have borrowed from PSA or ETS. I don't know for sure, but that would be the only one that I could consider would have.

Q. Did Twinleaf also receive fees from ETS?

A. Yes, sir.

Q. And how much—what is the total of that amount, as close as you can come?

A. We received $250 per phone, my staff. We were not on ETS or nor PSA's payroll. All of my staff, including legal, was all on Twinleaf's payroll; 90 percent of our time was spent managing and [65] working with ETS and PSA and the other companies.

Q. All right, sir, my question was, what was the total amount of fees that Twinleaf received from ETS?

A. I truly don't know, sir. I heard the gentleman say $3 million up here for the last 18 months. I would say that is fairly close.

Q. That was as of March of 1999. Would there be another million or two on top of that since that time?

A. I—we got paid up until we quit selling, and our income stopped when we voluntarily to quit selling, yes, sir.

Q. Did ETS also make investments in Twinleaf or any of those entities?

A. No, ETS made its investments in ETS vending, which is a company that puts out ATM's, and air, and air and vac machines in the convenience stores where we have payphones, and it also invested in POA, which is our limited partnership that owns the phones we have in Mexico.

Q. You mentioned Twinleaf Media. Is that the company that sells advertising kiosks?

A. No, it doesn't sell advertising kiosks. The kiosks are on ETS payphones or other payphones, and it sells the advertising that goes in these kiosks.

* * * * *

[66]

Q. What are Twinleaf's current assets?

A. Well, it wholly owns Legends—are you talking about actual or value?

Q. Value.

A. I would say approximately $13 to $15 million at actual costs.

Q. Now, how much of it that liquid, in cash and securities?

A. Very little of it would be liquid.

Q. So what is the bulk of it made up of?

A. Of actual businesses, operating businesses.

Q. Do any of your entities or yourself own an airplane?

A. No, sir. We leased a plane last year as a third party, three people leased a plane for approximately six months.

Q. What type of plane was that?

A. A Citation II.

Q. Is that a prop plane or a jet?

A. A jet plane.

[67]

Q. Who was it in particular that leased that plane?

A. Actually it was leased by Air Holdings, which is another wholly-owned subsidiary of Twinleaf, and with two other partners, Bullet Bob Turley, the Yankee ex-pitcher, was a partner and Chip McPhearson of Nations Development was the other third party that leased the plane.

Q. And you had a NASCAR racing team also?

A. Yes, sir.

Q. I would like to go into your current assets for a minute. How many houses do you own?

A. Four.

Q. Where are those houses?

A. Actually I own three, I'm sorry. We have one in Kingsport, that is my wife and I do; we have one on Sea Island; and one on St. Simons.

Q. Does your wife own any other houses besides those?

A. Yes. She owns a home in Duluth.

THE COURT: A home where?

THE WITNESS: In Duluth.

BY MR. HICKS:

Q. When were those homes purchased?

A. 1998. And—I think all three of them was purchased in 1998.

Q. About how much—what is the value of each of the houses?

A. The house on Sea Island, which is up for sale, which was an [68] investment, is for sale for $4.2 million. The house on St. Simons, which is also for sale, is 2.95.

Q. Million?

A. 2.95 million. And the one in Kingsport is $185,000.

Q. How about your wife's house? When was that purchased?

A. In 1996 or 1997.

Q. What is the value of that?

A. $6— or $700,000. I think it was bought for $610,000.

Q. All right. Do you have any cash or securities, liquid assets?

A. No. I have probably, cashwise, $2- or $3,000. I have my 401k, a SEP IRA 401, is basically all the cash I have.

Q. How much cash do you have in those accounts?

A. Approximately $21- or $22,000 in the 401; I have $23,000 in the SEP IRA—no, I'm sorry, it's got ap-

proximately $29,000. And I also do have approximately $27- or $28,000 cash value life insurance policy also.

Q. How much money did you personally take out of Twinleaf?

A. Last year?

Q. No. Over the course of the ETS operation.

A. The majority of my income came out of Twinleaf this year. Last year I took approximately $1.3 million out of Twinleaf, and this year I would have taken, for ten months—nine months. I'm at $360,000 a year, and I've got nine months of that pay.

Q. How about in 1998?

[69]

A. In 1998 it would be a combination of ETS and Twinleaf. It was approximately $900,000.

Q. You've attached to your affidavit a number of legal opinions.

A. Yes, sir.

Q. How many other law firms did you consult with on the subject of whether it is a security, other than what you've included here?

A. When I first started I worked with a gentleman by the name of Glenville Haldi. Then I worked with Shelley Freeman were the two initial ones I worked with. And then when—I am trying to think—Tom Sherman. I don't know which law firm he is with right now. But I had an opinion from Tom Sherman, then had an opinion from Powell Goldstein also.

Q. You have an opinion from Powell Goldstein or a draft?

A. A draft of an opinion. I'm sorry.

Q. Now, is it your testimony, based on your—based on your affidavit, that at some point some representative of the SEC told you that what you were doing didn't involve the securities laws?

A. No, sir. I did meet with a gentleman with the SEC that made a couple of recommendations to us that we did in fact do, and he said if we did those we would never hear from a regulatory agent, which of course is not true, and that was to give our lessors more control over their asset, and to either diversify [70] myself from the marketing or the leasing, because at that time I controlled both.

Q. Was that your conversation with Mr. Grant?

A. Mr. Larry Grant, yes, sir.

Q. When did this take place?

A. 1995.

Q. How big was your company at that time?

A. I would say we had 2 or 300 payphones at that time.

Q. I take it there was no discussion about Ponzi schemes or anything like that, was there?

A. No, sir.

* * * * *

Q. All right. Would it be true, I guess consistent with your prior testimony, that a 99 percent of the people who rent phones from PSA went into the lease back arrangement.

A. No, sir. But if you restated that a bit, it might be true.

[71]

Q. How would you restate it?

A. Ninety-nine percent of the phones that were sold by the distributors chose to lease phones with ETS.

Q. And just to be clear, when you talk about the distributors, you are talking about these insurance agents and people that sold the things on your behalf?

A. They were independent marketing people that sold a multitude of different products.

* * * * *

CROSS-EXAMINATION

BY MR. WOLENSKY:

Q. Mr. Edwards, I would like to address a couple of items that were raised initially here by Mr. Hicks. Now, is your wife an independent business person?

A. Yes.

Q. She had a business of her own, and had her own income?

A. Absolutely.

Q. And she bought this property with her own money?

A. Yes.

* * * * *

[74]

Q. Mr. Edwards, in connection with the business of ETS, how many employees have you got?

A. Approximately 450.

Q. And how many locations does the company have offices to service telephones?

A. We have 33 offices in the United States, one in Puerto Rico, one in the Virgin Islands, one in St. Thomas, and four in Mexico. And we have approximately 100 employees in Mexico in addition to that, too.

* * * * *

[77]

Q. Can you explain to the judge, please, the types of services, management services, that Twinleaf provides to ETS and PSA?

A. On the legal side, our inhouse counsel worked for Twinleaf so it could advise all the companies. Then, myself, I was the, up until four months ago, I was the CEO and I helped run the day-to-day operations of ETS. I am the CEO and president of PSA.

We—my assistant handled all the cash in from the marketing groups when they purchased equipment, and then she made sure it went to the proper departments, and then she verified with accounting every two weeks when we did lease [78] checks that the proper checks were sent out, and it was tallied. A check and balance system, is what I am trying to say. And it was just overall management. Ninety percent of all my time was spent with ETS and PSA, and ten percent with the other companies that we had.

Q. And this management fee was the management fee that covered all of the services provided over the several years that a telephone might be under lease; is that correct?

A. Correct.

Q. So if the management fee was $250 for a phone, and that phone—

THE COURT: Was that the management fee?

MR. WOLENSKY: That is the current one, your Honor. It was $125.

BY MR. WOLENSKY:

Q. And when was that raised to 250, Mr. Edwards?

A. The first of this year.

Q. The 1st of 2000?

A. Yes.

Q. So currently that $250, if that phone were to stay under lease for five years, all of the management services provided by Twinleaf over that five-year period would be covered in that $250, or about $50 a year; correct?

A. Correct.

Q. Was that the normal expected time of a lease, five years?

[79]

A. No. And I am giving you a personal opinion working based on working with the lessors. We felt the term of our lease would run closer to ten years because I've gotten numerous calls where they wanted to extend their lease prior to even getting to near five years, because we always paid and paid on time.

Q. May I have just one moment, Your Honor?

(PAUSE).

MR. WOLENSKY: That is all I have of Mr. Edwards for now, Your Honor.

* * * * *

[81]

LARRY GRANT

PLAINTIFF'S WITNESS

SWORN

DIRECT EXAMINATION

BY MR.HICKS:

A. Joseph L. Grant.

Q. Good afternoon, Mr. Grant. You were formerly an attorney with the SEC?

A. I was.

Q. And when did you leave?

A. Three years ago, in 1997, August.

Q. And now at some point approximately five years or so ago did you have a meeting or meetings with Mr. Charles Edwards related [82] to a payphone business?

A. I did.

Q. Did you at any time advise him that what he was telling did not involve the sales of security?

A. I certainly did not. As a matter of fact, I indicated that it was my opinion that they were offering an investment contract when he first came in.

Q. Did you offer him any opinion that if he did this or he did that that he would not have any trouble from regulators or that it would be a security?

A. No, I did not.

MR. HICKS: Just a minute, Your Honor.

(PAUSE).

BY MR. HICKS:

Q. Did you have any indication at the time—first of all, did you get any financial information about the company at the time?

A. Did I get any financial?

Q. Yes.

A. I'm not sure. They did provide material. They were cooperative when he came in. I think he came in the first time by himself, and then at a couple of subsequent meetings he was represented by an attorney.

Q. All right. Did—was there any indication at that time that the company was or was going to operate as a Ponzi scheme?

[83]

A. No. Not to my recollection. As a Ponzi scheme? Not to my recollection.

Q. And in fact, how big was the company in terms of the amount of payphones that was represented to you at the time?

A. It was very nominal at that particular time. If I recall, I don't think they had more than 30 investors. If I recall, they were—they had some, to the best of my recollection, they were registered with—either with some state authority, I believe, and had some materials that they were providing to their proposed investors.

Q. Did they indicate to you that they were going to stop selling the investment?

A. They came in subsequently and the attorney said that Mr. Edwards was going to engage solely in the sale

of the telephones, and not be involved in the other activities which, in my view, made it an investment contract, which was that they were finding the locations, they were putting the phones in, and servicing the telephones for the investors, so that the investor was merely passive, he simple provided the money for the telephone, although they said that the investor could decide where he wanted to put the telephone himself and arrange for all of his own activities.

Q. So they represented to you they were not going to do all of those collateral activities?

A. That is correct.

[84]

MR. HICKS: No Further Questions.

CROSS-EXAMINATION

BY MR WOLENSKY:

Q. Mr. Grant, when you handled this inquiry was there a file opened on it?

A. An informal, probably MUI, as we called it, Matter Under Inquiry.

Q. Were materials gathered from the company and other places?

A. To the best of my recollection, they provided some materials, I think a list of people that they had obtained monies from for telephones. And as I said, I recall, for some reason, some materials that they had put together, kind of like an offering of materials.

Q. And when you left the SEC you left that file?

A. Yes.

Q. As far as you know, the—

A. I didn't take any files with me.

Q. As far as you know, the SEC still has that file?

A. As far as I know.

Q. Now, the discussion that you had, you understood that there was going to be a split so that the company would not be both engaged in sales and in management of phones. Was that you understanding?

A. That is what the attorney represented.

Q. And in your view would that have eliminated the problem of [85] this being, as you said before, possibly an investment contract?

A. Not necessarily. No.

Q. Did you—

A. I told them that the mere fact that I wasn't recommending any action at that particular time did not mean that they were in compliance with the securities laws, and emphasized, as I normally did in preliminary inquiries, that even if they didn't have to comply with the registration provisions, that there was no exemption from the anti-fraud provisions of the federal securities laws.

* * * * *

[86]

Q. Did the SEC take any action against Mr. Edwards at that time?

A. Not to my knowledge.

* * * * *

[89]

JAMES D. BLYTH

DEFENDANT'S WITNESS

SWORN

DIRECT EXAMINATION

* * * * *

[92]

THE COURT: And why in the years of 1993 and 1994 and 1995 was there an apparent expansion of companies in the payphone business?

THE WITNESS: Primarily I believe, Your Honor, due to the 1996 Telecommunications Act. And as part of that act the FCC and their regulations promulgated compensation for dial-around calls, which are 800 calls originated from public payphones. And in the original order the FCC intended for the long distance carriers to pay $45.85 per payphone per month as a surrogate rate while all of the details were being worked out for the per-call compensation. And I think that's the primary reason that there was a proliferation of public payphones during that period of time.

THE COURT: Okay. Who owned the public payphones [93] prior to that time?

THE WITNESS: In 1984, as part of the divestiture, prior to that time, prior to 1984, all of the public payphones were owned by the regional Bell operating companies. As a result of Judge Green's decision, breaking up the Bell operating companies, it allowed for competition.

Between 1985 and 1987 the—we call the Cocot industry, or private independent payphone operations, started up in this country, and there have been a number of companies that have spawned out of that over that period of time. And the overall picture, there is about two-and-a-half million public payphones prior to divestiture, and now there is about 600,000 that are independently owned, and the rest are owned by the regional Bell operating companies.

* * * * *

[PLAINTIFF'S EXHIBIT 1]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. _____

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES, INC., DEFENDANT

DECLARATION OF DAVID H. CRUMPTON

I, David H. Crumpton, declare pursuant to the provisions of 18 U.S.C. 1746:

1. I am a Certified Public Accountant who maintains a current license in the State of Georgia. I am a member of the American Institute of Certified Public Accountants and the Georgia Society of CPAs; however, I am not currently engaged in the practice of public accounting.
2. I am a Principal and the Chief Financial Officer of Newleaf Corporation. In that capacity, I have extensive engagement experience as forensic accountant, receiver, bankruptcy examiner, financial advisor to bankruptcy trustees, and

other financial consulting services to financially distressed and/or bankrupt business enterprises.

3. My office address is 2810 Spring Road, Suite 106, Atlanta, Georgia 30339. My telephone number is 770-433-9400.

4. I have been asked by the staff of the Securities and Exchange Commission to assist it in providing review and analysis of various financial statements and other documentation provided by ETS Payphones, Inc. ("ETS").

5. I have first hand knowledge of the contents of this declaration.

6. In connection with my duties in conjunction with this matter, I reviewed and analyzed the following unaudited financial statements (the "Financial Statements") of ETS:

   a) Unaudited financial statement (labeled drafts) for the year ended December 31, 1998 compiled by independent accountants;

   b) Unaudited financial statements for the fifteen month period ended March 31, 1999 compiled by independent accountants;

   c) Internally prepared, unaudited financial statements for the year ended December 31, 1999; and

   d) Internally prepared, unaudited financial statements for the six months ended June 30, 2000.

7. I have not independently verified the accuracy or validity of the numbers and other information included in the Financial Statements.

8. ETS is engaged in the sale of payphone units ("PPUs"), and ETS leases the PPUs back from the purchasers/lessors (the "Lessors") over five (5) year lease terms. The leases require ETS to pay lease payments to the Lessors on a monthly basis. The lease agreements provide that the Lessor has a "put" option to require ETS to repurchase the PPU at any time during the term of the PPU lease upon 180 days notice for the Lessor's original purchase price.

9. The ETS Financial Statements (except those financial statements for the fifteen month period ended March 31, 1999) show the funds received from the PPU sales to Lessors as income in the accounting period in which the related PPUs are placed in service. This method of accounting does not conform with generally accepted accounting principles which require that the sale and leaseback of the PPUs be treated as capital leases in the Financial Statements. Under the capital lease method of accounting, lease obligations are shown in financial statements as financing arrangements whereby the PPU assets and a corresponding capital lease obligation liability are recorded on the balance sheet in the amount of the discounted present value of the lease payments based on the annual interest factor inherent in the lease. Further, this method of accounting does not permit the cash receipts from the PPU sale transactions to be treated as revenue or as income. (The financial statements for the fifteen month period ended March 31, 1999, purport to conform with gen-

erally accepted accounting principles and follow the capital lease method of accounting.)

10. ETS operates and services the operations of PPUs, retains for its own account all of the telephone calls operating revenues, and pays from its own account all of the PPU maintenance and operating expenses.

11. The total operating revenues of ETS from sources other than initial PPU sale transactions (i.e., primarily its telephone calling operations) amounted to ($ in thousands):

	Calendar 1999	6 M/E 6/30/2000
Operating Revenues	$ 47,381	$ 29,255

12. The total operating costs and expenses of ETS (including general and administrative expenses, but excluding route purchases, equipment purchases, lease refunds, and other costs of initial PPU sale transactions) amounted to ($ in thousands):

	Calendar 1999	6 M/E 6/30/2000
Telephone calling operations expenses	$44,538	$29,166
Lease payments	29,517	22,903
General and administrative expenses	14,715	10,449

Total operating costs and expenses	$ 88,770	$ 62,518

13. The Financial Statements indicate that ETS has derived the following amounts of profit from the payphone sales transactions with the Lessors of the PPUs ($ in thousands):

	Calendar 1999	6 M/E 6/30/2000
Payphone sales	$ 125,634	$ 51,979
Costs of payphone sales, including lease refunds	80,590	8,170
Profits from payphone sales	$ 45,044	$ 43,809

14. ETS's Financial Statements do not reflect any significant sources of cash to ETS other than from the operating revenues set forth in item 11 hereof, which are substantially exceeded by the operating expenses set forth in item 12 hereof, and from the payphone sales transactions with the Lessors of the PPUs set forth in item 13 hereof.

15. The ETS balance sheet reflects accounts receivable from affiliates of $11,629,000 and investments in subsidiaries of $6,192,000 as of June 30, 2000, for a total of $17,821,000 invested in or advanced to related parties or affiliates. These amounts include net increases in such invest-

ments and advances of $10,993,000 in calendar year 1999 and $2,391,000 in the six months ended June 30, 2000. The notes to the financial statements for the fifteen month period ended March 31, 1999, state that the accounts receivable due from affiliates consist of loans made to companies controlled by the primary shareholder of ETS, that the loans are non-interest bearing, and that the borrowing entities did not have cash on hand, at that time, to repay the loans.

16. Based on the foregoing financial information, the financial activities of ETS related to the sale and leaseback of PPUs, the operations of the PPUs and investments in, and advances to, affiliates may be summarized as follows ($ in thousands):

	Calendar 1999	6 M/E 6/30/2000
Summary of Uses of Cash		
Operating Revenues	$ 47,381	$ 29,255
Telephone calling operations expenses	44,538	29,166
Lease payments	29,517	22,903
General and administrative expenses	14,715	10,449
Total operating costs and expenses	88,770	62,518

Net losses from operations	41,389	33,263
Investments in and advances to affiliates, net	10,993	2,391
Total operating losses and payments to affiliates	$ 52,382	$ 35,654
Financing of Operating Losses and Payments to Affiliates-		
Payphone sales	$125,634	$ 51,979
Costs of payphone sales, including lease refunds	80,590	8,170
Profit from payphone sales	$ 45,044	$ 43,809

17. The ETS Financial Statements reflect total net income from all activities of $2,490,000 in calendar year 1999 and $10,402,000 for the six months ended June 30, 2000. If the Financial Statements had treated the PPU sale and leaseback transactions as capital leases as required by generally accepted accounting principles, the profits from the payphone sales transaction would not be recognized as income. If the PPU profits from payphone sales of $45,044,000 for calendar year 1999 and $43,809,000 for the six months ended June 30, 2000, were subtracted from the reported net income, then ETS would have reported net losses of $42,554,000 and $33,407,000 in the respective periods. (The statement of

operations for the fifteen month period ended March 31, 1999, which purports to follow generally accepted accounting principles, reflects a net loss of $26,770,000.)

18. The balance sheet of ETS as of June 30, 2000, reflects positive stockholders' equity (i.e., total assets in excess of total liabilities) of $12,591,000. If this balance sheet had treated the PPU sale and leaseback transactions as capital leases as required by generally accepted accounting principles, the PPU repurchase obligation under the leases would be recorded as a liability. Since ETS is obligated to repurchase the PPUs from the Lessors for an amount equal to the original sales price, the amount of this liability would substantially equate to PPU sales revenues derived from the PPU leases currently in effect. Further, the capital lease accounting treatment requires that the costs directly associated with the PPU sales revenue (equipment and route purchases, sales commissions, etc.) be recorded on the balance sheet at the lower of depreciated cost or net realizable value. Based solely on the PPU sales activity of ETS for calendar year 1999 and the six months ended June 30, 2000, (i.e., totally ignoring lease obligation liabilities and costs arising from PPU sales for periods prior to January 1, 1999), the adjustments to treat such PPU sale and leaseback transactions as capital leases would result in a decrease in stockholders' equity by a minimum amount of $88,853,000, which amount represents the total reported profits from PPU sales transactions during such period. If this $88,853,000 adjustment to reduce

stockholders' equity were subtracted from the reported stockholders' equity of $12,591,000 at June 30, 2000, then ETS would have reported a deficiency in stockholders' equity (i.e., total liabilities in excess of total assets) of $76,262,000 at that date. (The balance sheet as of March 31, 1999, which purports to follow generally accepted accounting principles, reflects a deficiency in stockholders' equity of $24,493,000.)

19. The balance sheet of ETS as of June 30, 2000, reflects a deficiency in working capital of $6,378,000 representing the excess of current liabilities of $37,503,000 over current assets of $31,125,000. The PPU lease agreements require ETS to repurchase the PPUs from the Lessors upon 180 days notice, and as previously stated herein, the capital lease obligation liability is not reflected on the ETS balance sheet. The PPU repurchase obligations, based solely on the total PPU sales activity for calendar year 1999 and the six months ended June 30, 2000, (i.e., totally ignoring lease obligation liabilities arising from PPU sales for periods prior to January 1, 1999), represent a liability of $177,613,000 for the total sales during this period. Since the Lessors have the right to exercise their PPU repurchase rights upon 180 days notice to ETS, the full amount of this capital lease obligation liability could be reflected on the balance sheet as a current obligation. If this $177,613,000 current liability were added to the reported working capital deficiency of $6,378,000 at June 30, 2000, then ETS would have reported a working capital deficiency of $183,991,000 at that date. (The

balance sheet as of March 31, 1999, which purports to follow generally accepted accounting principles, reflects a total capital lease obligation liability of $164,383,000.)

20. Based on the foregoing observations and the application of generally accepted accounting principles to the Financial Statements, the following conclusions may be reached:

    a. ETS is insolvent at June 30, 2000.

    b. In the event that any significant number of Lessors should exercise their put options to require ETS to repurchase their PPUs, ETS would be unable to meet its current obligations, as indicated by the deficiency in working capital at June 30, 2000.

    c. ETS's operations of the pay telephone business have not been profitable. Over the eighteen months ended June 30, 2000 and the fifteen months ended March 31, 1999, ETS's operating expenses have substantially exceeded ETS's operating revenues.

    d. Inasmuch as ETS's operations of the pay telephone business have not been profitable, coupled with the fact that ETS's only other significant source of cash has been derived from payphone sales transactions with Lessors of the PPUs, the payphone sales transactions have been the source of cash to finance (i) ETS's operating losses from telephone operations, (ii) the monthly rental payments made to the Lessors of the PPUs,

and (iii) the payments which ETS has made to its affiliates.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 20th day of September, 2000.

/s/ DAVID H. CRUMPTON
DAVID H. CRUMPTON

[PLAINTIFF'S EXHIBIT 6]

DECLARATION OF A.S. GIBBS

I, A.S. Gibbs, declare under penalty of perjury that:

1. I have personal knowledge of all facts stated herein.
2. I am currently 86 years old. I am also retired.
3. I became aware of ETS Payphones, Inc. ("ETS") approximately three or four years ago through Mr. Phil Hayhill, a financial adviser with Eco-Cash Management.
4. I initially purchased a total of 25 payphones from ETS. My total investment in those payphones was $175,000.
5. I purchased an additional six payphones from ETS around two months ago. My total investment in those payphones was $42,000.
6. According to information received from ETS, my payphones are located in Texas and Florida. However, I have never actually seen my payphones. None of my payphones are located near my residence in Stuart, Florida.
7. I invested my money in ETS because it appeared to be a good investment opportunity and offered a good rate of return. I did not enter this investment with the idea of actually operating any payphones myself.
8. I leased all my payphones back to ETS. I receive monthly lease payments from ETS of approximately $80 per payphone.

9. I signed an agreement with ETS in which ETS promises to buy back my payphones within 180 days at my request.
10. I have always received my monthly lease payments from ETS. I have not yet exercised any buyback agreements.
11. I do not manage any of my payphones nor do I intend to ever manage any of my payphones. In fact, I do not possess the expertise to manage payphones. All of my payphones are managed by ETS.
12. Neither ETS or any of its representatives have ever informed me, either before or after making my investment, that the receipt of my monthly lease payments is dependent on the sale of payphones to new ETS investors.
13. Neither ETS or any of its representatives have ever informed me, either before or after making my investment, that ETS payphone operations are not profitable.
14. Neither ETS or any of its representatives have ever informed me, either before or after making my investment, that if a significant number of investors decided to exercise their options to sell their payphones back to ETS, that ETS does not have the available financial resources to satisfy its obligations.

Pursuant to 28 U.S.C. 1746, I declare under penalty of perjury that the foregoing is true and correct.

Executed this 9 day of September 2000.

/s/ A.S. GIBBS
A.S. GIBBS

[PLAINTIFF'S EXHIBIT 7]

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

File No. A-02501

IN THE MATTER OF ETS PAYPHONES, INC.

INVESTIGATIVE INTERVIEW

TRANSCRIPT

APPEARANCES:

On behalf of the Securities and Exchange Commission

BARRY R. LAKAS, Staff Accountant
Securities and Exchange Commission
Suite 1000, 3475 Lenox Road
Atlanta Georgia 30326
(404) 842-7600

On behalf of the Witness

HUBERT FOUASSE, *PRO SE*

[3]

* * * * *

HERBERT FOUASSE

being first duly sworn, was examined and testified as follows:

EXAMINATION

BY MR. LAKAS:

* * * * *

[7]

Q. Okay. Your educational background, and briefly that would be just the year you graduated high school, any college degrees.

A. High school '68, bachelor of arts '71, bachelor of education '77, D.C. in 1981, in chiropractic orthopedics in '87.

Q. What colleges did you attend?

A. My bachelors degrees were from the University of Manitoba; Life College was the chiropractic degree; and the chiropractic orthopedics was done through Los Angeles Chiropractic College; and a lot more post-graduate work that I really don't want to go through.

* * * * *

[12]

A. Okay. Let's go to the substance of the questions here.

You are in investor in ETS Payphones, Inc.; is that correct?

A. Yes.

Q. When did you invest?

A. The first investment was March of '97.

Q. And how much did you invest?

A. That initial investment?

Q. Yes.

A. $5,000.

Q. So you bought one pay phone?

A. That's right.

Q. And who sold you this investment?

A. B.E.E. Communications.

Q. How did you hear about this investment?

A. A friend of mine.

Q. Did he put you in contact with anyone? In other words, did this friend buy this investment from a certain individual or entity?

A. He bought it from B.E.E. Communications.

Q. Okay. So you directly contacted B.E.E. [13] Communications?

A. I believe I did, yeah.

Q. Who did you contact there?

A. The name that comes to mind, because I think she was I think running B.E.E. Communications at the time, is Beverly Slater.

Q. So you contacted Beverly Slater directly?

A. Uh-huh.

Q. So you did not buy your investment through a life insurance agency?

A. No.

Q. You didn't buy it through a life insurance agent?

A. No.

Q. What was represented to you about this investment? Who made the representation?

A. Beverly Slater at B.E.E. Communications, and—Do you want me to go through the content of what was said?

Q. Yeah, whatever she told you. Did you already know a lot about the investment when you contacted Beverly Slater?

A. I knew what my friend had told me about it, what he knew about it, and that the investment was $5,000, and that you would be an owner of a phone, a location, and actually a physical phone, and that there would be a lease involved with ETS to perform management of these particular phone, management as far as running the day-to-day operation [14] of the phone, and that there would be a lease document, and that I would be paid I believe on the initial phone was $75 a month.

Q. So you went into this with the idea of this just being an investment; is that correct?

A. Uh-huh, yes.

Q. You did not go into this with the idea of actually buying a pay phone and running it yourself?

A. No. That option was offered, but I was not interested in that.

Q. Did she offer that option to you?

A. Yes.

Q. And that option would be that you could manage the pay phone yourself?

A. Right.

Q. Did she in any way encourage you to take the management option?

A. No. They left everything up to myself to decide.

Q. But you yourself knew nothing about operating a pay phone?

A. No.

Q. Did they offer any type of rate of return? By they I mean Beverly Slater and B.E.E. Communications.

A. Well, $75 a month on a $5,000 investment initially over a period of five years turns out to be I think 18 [15] percent.

Q. Did B.E.E. or Ms. Slater tell you that you could get your money back at any time on your investment?

A. Yes, uh-huh.

Q. That would be the full $5,000?

A. Yes.

Q. Could you go into that a little if you don't mind, just basically what she told you about that.

A. Yeah. The phone could be liquidated at any time. I believe as the contract states if I notify them that I want to liquidate the phone they would have 180 days to return the initial investment of $5,000.

Q. So basically you have to give them 180 days?

A. Right.

Q. Now, when she mentioned ETS Payphones would manage the pay phone, did she mention any other companies that might manage the pay phone?

A. Not that I recall.

Q. Did she tell you anything about ETS Payphones itself?

A. She told me about the principle involved, I guess.

Q. What did she say about ETS Payphones?

A. That they were a growing company, and that they had ambitions to be probably the biggest phone operators in the States.

[16]

Q. Did she give you any type of documents before you bought?

A. Yes.

Q. I'm not going to enter this as an exhibit yet. Does this look familiar?

A. Yes.

MR. LAKAS: Let's enter this as an exhibit.

[Exhibit Number 17 was marked for identification.]

Q. I'm handing the witness Exhibit Number 17 which is a B.E.E. Communications brochure, it includes a pamphlet entitled Opportunity Doesn't Always Knock, Sometimes it Rings, with a B.E.E. Communications logo on the bottom of the pamphlet. I'll let you look at that for a minute.

A. Okay.

Q. Have you ever seen that document before?

A. Yes.

Q. Is that what Beverly Slater handed you before the investment?

A. Yes.

Q. And did you read this document beforehand?

A. Yes.

Q. So when did you actually decide to make the investment? Right after you looked at this?

A. Yeah, that, and discussing this particular [17] investment with my friend.

Q. Did this brochure influence your investment decision in any way?

A. Well, it reiterated the options that are in there about which methods, levels of investment could be made, or I guess involvement.

Q. How about the fact that smart phones are profitable; did that influence your investment decision in any way?

A. Sure.

Q. Did you happen to read this box in the middle of the brochure about the economics of the medium-volume pay phone? Do you remember seeing that?

A. Yes.

Q. Did that influence your decision in any way?

A. Yeah, I suppose.

Q. Well, if you don't remember—

A. Yeah, as far as I can recall.

Q. So when you—this was March of 1997, when you decided to make the pay phone investment who did you write your check to?

A. B.E.E. Communications.

Q. And who did you give it to? Who did you give the check to?

A. B.E.E. Communications.

[18]

Q. But I mean who did you personally hand it to? Did you mail it to them?

A. I think I mailed it to B.E.E. Communications.

Q. And how was ETS Payphones going to come into the picture, then?

A. Well, as far as I know they're a management company of pay phones, so I was sent a copy of a sample lease, and proceeded from there.

Q. Did your friend tell you about ETS Payphones, or was it Beverly Slater?

A. It was my friend originally.

Q. On the last page of the brochure or the pamphlet included in Exhibit 17 there's a reference to ETS Payphones, Inc., but you already knew about ETS Payphones beforehand?

A. Yes.

Q. Before you made your B.E.E. investment.

A. Uh-huh.

Q. So ETS Payphones just was recommended by your friend and Beverly Slater?

A. Right.

Q. It was just understood you would be working with ETS Payphones on this?

A. Yes.

Q. Did you look at any other management companies?

A. No.

[19]

Q. Okay. So you made your $5,000 investment with B.E.E. Communications in March of '97. I assume you made the check out to B.E.E. Communications?

A. I believe so, yeah.

Q. And how long did it take you to hear from ETS Payphones? I assume they had to send you a form.

A. Yes, they sent a lease packet with—I think it was the sample lease packet, and that was probably within two or three weeks.

Q. So you filled out the lease packet, is that where ETS then leases the phone back from you, the investor? Is that how it's supposed to work?

A. Yeah.

Q. Did you ever talk to anyone from ETS?

A. Not initially after that first investment. It was a while before I did. I visited their—

Q. Oh, you did visit?

A. —within the year if I recall.

Q. Because you invested in March of 1997, when did you receive your first investment return check?

A. About sixty days later.

Q. And you had already filled out the ETS paperwork about the leasing program?

A. Uh-huh.

Q. When you filled out the leasing package for ETS [20] Payphones, do you have a copy of that lease package? I would just like to know what they gave you at the time.

A. I think this is it here. Yeah. Did you get a copy of that?

Q. Okay. Actually let's go through this bill of sale I guess you entered into with B.E.E.

[Exhibit Number 18 was marked for identification.]

Q. I have in front of me Exhibit Number 18, the title of the first page is Pay Phone Package COCOT Bill of Sale, it's a bill of sale executed the 1st of March 1997 between B.E.E. Communications and Hubert Fouasse. It's signed by B.E.E. Communications, Beverly Slater as the manager.

So this is what you originally signed with B.E.E. Communications for selling you the pay phone?

A. Right.

Q. Flipping over three pages, you signed a telephone equipment lease agreement. It says you're the lessor, and ETS Payphones, Inc. is the lessee, so the equipment lease agreement was basically done at the same time as when you purchased the pay phone; is that correct?

A. According to the dates there, yes.

Q. So do you know if this came later? Or was this just all done at the same time? This indicates it was done at the same time.

[21]

A. This document here?

Q. Yeah.

A. It came later.

Q. It did come later?

A. Uh-huh.

Q. And the option to sell agreement which is in the back of this document. That's also dated the 1st of March, 1997.

A. Uh-huh.

Q. What is this agreement saying?

A. Between myself and ETS Payphones.

Q. This is the document that says you have the right to sell the pay phone back to ETS Payphones?

A. According to the document it would appear to be, yeah.

Q. Yeah, it talks about the 180 days.

Well, in substance, though, maybe these documents came later, but according to ETS Payphones they considered that you entered into this agreement on the 1st of March 1997; is that correct?

A. Yeah.

* * * * *

[22]

Q. You said you made another investment in B.E.E. Communications; is that correct?

[23]

A. Yes.

Q. And what was the date of that investment?

A. November of '99.

Q. And how much money did you invest the second time?

A. $7,000.

* * * * *

[24]

Q. The lease date, okay. So you actually invested $7,000 on September 10th, 1999?

A Right.

Q. And the lease agreement started on November 2nd, 1999?

A. Right.

Q. Do you know where your pay phones are located?

A. This particular one here?

Q. Both of them.

A. Yes. It's in the documents.

Q. Have you ever—Well, just to the best of your recollection.

A. I have never visited my pay phones, though.

Q. But you have received all your monthly lease payments?

A. Yes.

Q. And you did request a refund on—Or you did elect the option to sell your pay phones; is that correct?

A. Yes, some of it.

[25]

A. Some of it?

Q. Yeah.

A. You still own one?

Q. I still own the first one here.

A. Oh, you still own the first one?

Q. Uh-huh.

A. So you did receive your $7,000 back?

Q. On one of the phones, yes.

A. And when did you request your refund?

Q. When did I request it?

A. Yes.

Q. I believe February of this year.

* * * * *

[34]

Q. Are you yourself an agent for B.E.E. Communications?

A. Yes.

Q. And have you sold pay phones?

A. Yes.

Q. And how many have you sold?

A. About fifteen or so.

Q. But even as an agent for B.E.E. did you have any meetings with ETS?

[35]

A. No.

Q. Who trains you to be an agent?

A. B.E.E. Communications.

* * * * *

[37]

Q. Did anyone ever tell you or inform you that your pay phone location could increase in value?

A. I don't recall anybody ever making that statement, but it sounds to me like it could, you know, and there was an increase in price of the phones over the period of time that I initially invested and today.

Q. So that's just speculation on your part, though?

A. Just speculation.

Q. You have never seen any proof of a pay phone location going up in value?

The way I understand it there may be a pay phone sitting in a 7-11 store somewhere, and a company like ETS might have the rights for that location, and your claim is that that location could actually go up in value even though they sold it to you for seven thousand, but the claim is that that site might be worth 10,000 now.

A. Uh-huh.

Q. You haven't seen any proof of that?

A. No, I haven't. I have not seen any documentation on that. If I recall, my friend may have mentioned that that's a possibility, and that sounded like a possibility to me, too.

* * * * *

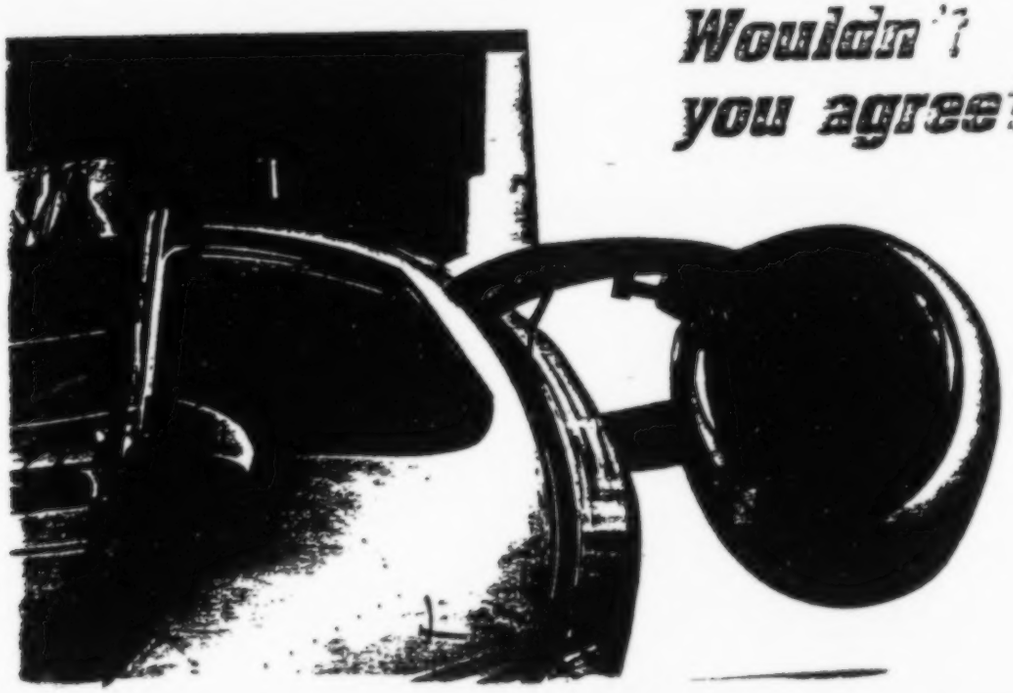
PLAINTIFF'S EXHIBIT 15

Opportunity Doesn't Always **Knock** *Sometimes It* **Rings!**

B·E·E
COMMUNICATIONS

Of all the individuals who are wealthy today...

A great majority became so by owning property or another valuable asset that has increased in value.



Wouldn't you agree?

Property, For Example:

Annual Income	$7,200
Annual Mortgage & Tax	$6,500
Repairs and Maintenance	$500
Net Annual Income	**$200**

After 15 years, assuming a 5% annual rent increase and a paid mortgage.

Annual Income	$14,400
Annual Mortgage & Tax	$1,200
Repair and Maintenance	$1,200
Net Annual Income	**$12,000**

You would also receive valuable tax breaks such as the depreciation and expense deductions of repairs. However, that also cuts into your short term income.

Now you know one of the secrets of how many people become financially independent.

Of course you will have to maintain the house in good repair, deal with tenants, and hold it for a long time.

Alternative — What if?

Instead of a house, you possessed an asset that would:

- Have no tenants.
- Provide immediate cash flow.
- Be an all cash business.
- Be fully insured.
- Have easy liquidity.
- Require holding for 5 years or less.
- Offer several management options.

What if...

the asset was a PAYPHONE?

Yes a payphone!

Not just any payphone...but a **Smart Phone**

The Smart Phone Difference

Did you know that all payphones are not **Smart Phones**?

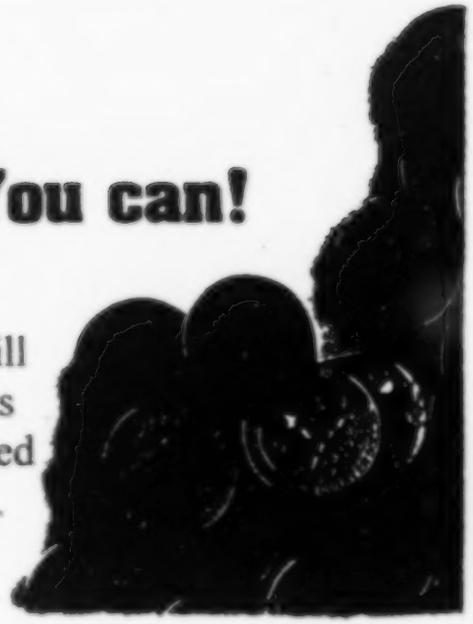
A Smart Phone

- Is monitored 24 hours a day.
- Calls in to report any mechanical or electrical problems.
- Has electronic coin acceptors.
- Is surge protected.
- Has waterproof keypads.
- Is designed for future upgrade. (Will not become obsolete)
- Is on the cutting edge of technology.
- Has discounted long-distance. (This means increased usage)
- Is a turn-key package.

What if *You* Could Own Such a Payphone?

For a limited time, You can!

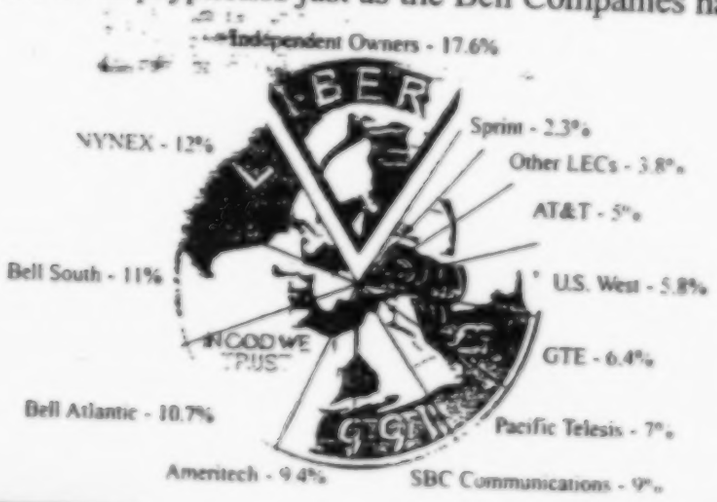
For a limited time, this opportunity will be available in the telecommunications industry to own your own coin-operated payphone and earn a very good profit.



Ownership

Until recently, almost all payphones have been owned and operated by the Bell Telephone Companies. As a result of deregulation they are now divesting themselves of the ownership and operation of these payphones.

This presents a special opportunity for individuals to own payphones and earn profits from payphones just as the Bell Companies have done.



Smart phone ownership offers a unique opportunity.

Payphone ownership...

...is virtually recession proof.

...can produce revenue 24 hours a day, 365 days a year.

...can offer immediate, steady cash flow.

...may provide significant income tax benefits.

"There a

Why Are Smart Phones So Profitable?

Payphones generate revenue in many ways:

- Coin Calls.
- Calling Card Calls.
- Credit Card Calls.
- Collect Calls.
- Dial-Around Calls.

Here is an example of the revenue generated by a medium volume payphone:

Incremental Economics of a Medium - Volume Payphone

	Monthly	Annually
Revenue - Coin	$200	$2400
Revenue - Non Coin	98	1176
Total Revenues	$298	$3576
Telephone Line	42	504
Site Commission	75	900
Long Distance Charges	17	204
Cost of Revenues	134	1608
Gross Margin	$164	$1968

CAUTION: These figures are only examples of what may be earned on a medium-volume payphone. Site commissions, fees and long distance charges may vary with locations of payphones.

millions to be made from owning payphones."

USA Today

Option 1

Internal Maintenance Program

This is for the payphone owner who wants to be involved with the day-to-day operation of his payphones, but lacks the technical expertise to do so. This option allows the owner to take full advantage of the income potential of the payphone industry.

We will provide you a turn-key operation with the payphones in place and operating on your site after State Certification. You will service the payphones each month, collect the revenue and maintain the payphones as needed.

Option 2

Turn-Key Maintenance Program

Option Two is for the payphone owner who would like to be less involved with the day-to-day operations of the payphone business and who wants to take advantage of the income potential on a profit or loss basis.

We will provide you with payphones in place and operating. A payphone management company will manage and maintain the payphones including all internal and external maintenance, repair and collections for a monthly fee.

Option 3

Payphone Equipment Leasing

Option Three is for the payphone owner who would like a payphone management company to be involved in the day-to-day operation of the payphones.

We will provide you with payphones in place and operating. A payphone management company will lease your payphones for five years at $80 per month for each payphone.

At the end of your lease, you have three choices:

a. **You may take over the maintenance and operation of the payphones.**

b. **You may elect to enter into another five year lease with the phone management company if mutually agreed upon.**

c. **You may sell your payphones for the original purchase price.**

Plus, with a 90 day notice, you may take over the operation of your payphones and locations at any time during the lease. Or, with a 180 day notice, the payphone management company will liquidate your payphones and locations with no penalty.

BEST AVAILABLE COPY

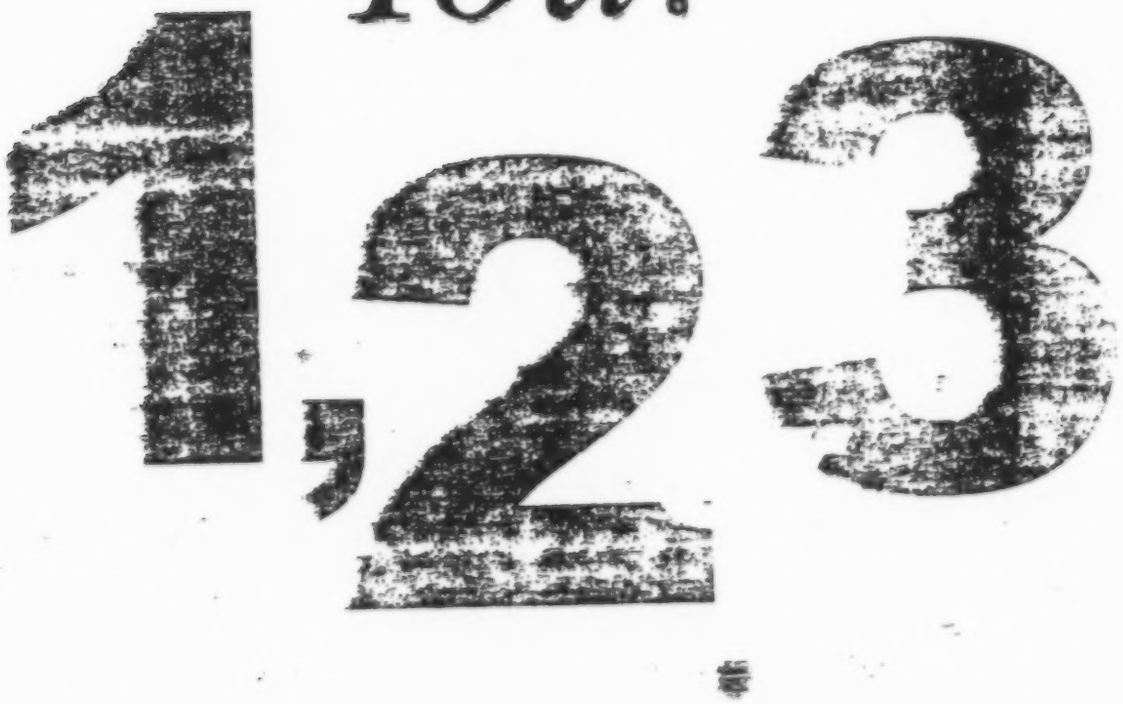
Bottom Line

The purchase price for a payphone, complete with location, and ready to operate: $6,750.

Self-directed IRA, Keogh, SEP and 401K plans may be used to fund the purchase of these payphones. (Option 3 only)

Opportunity Doesn't Always **Knock** *Sometimes It* **Rings!**

Which Option is Best For *You?*



Taking advantage of this opportunity is simple.

For information purposes only.

ETS PAYPHONES

ETS Payphones, Inc., based in Lithia Springs, GA is a state certified owner and operator of thousands of payphones currently operating in many states.

ETS Payphones, Inc. has available a payphone Equipment Lease Program whereby the owner may lease his/her phone to ETS, or you may elect to hire ETS as the professional manager of your payphones.

If you are interested in this program please fill out the bottom half of this form, detach and FAX to the ETS Home Office.

Fax (770) 319-9233

YES, I am interested in the Equipment Lease Program!

☐ I HAVE received the "Payphone Equipment Lease Program" package.

☐ I have NOT received the "Payphone Equipment Lease Program" package.

Date: _____

Name _____
PRINT CLEARLY PLEASE

Address _____

City, State, ZIP _____

Daytime Phone Number (BP)

☐☐☐-☐☐☐-☐☐☐☐

Night Phone Number

☐☐☐-☐☐☐-☐☐☐☐

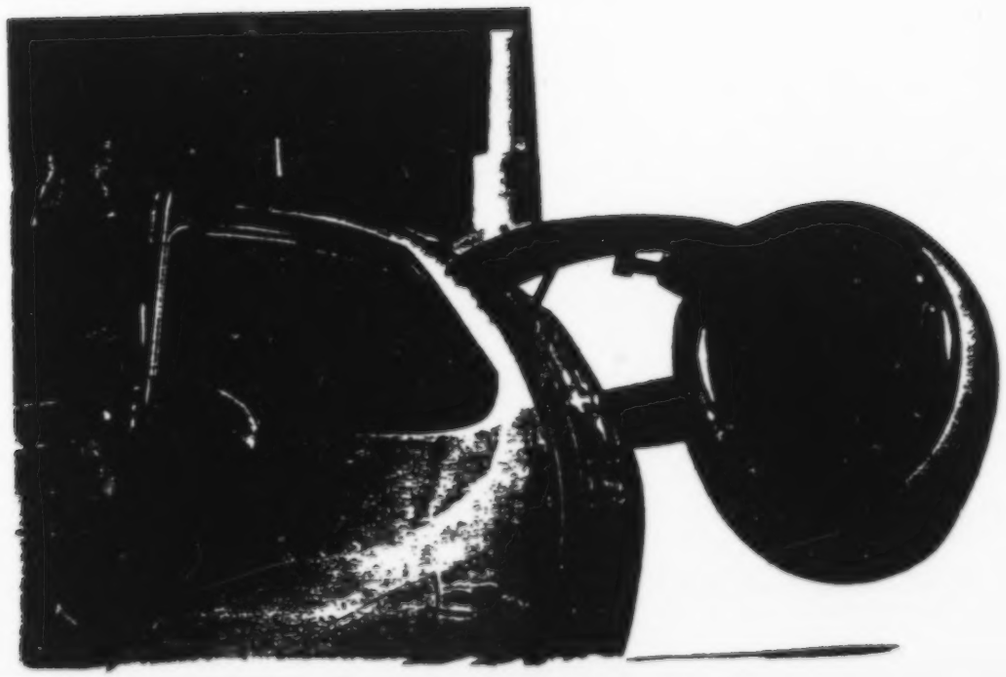
ETS PAYPHONES

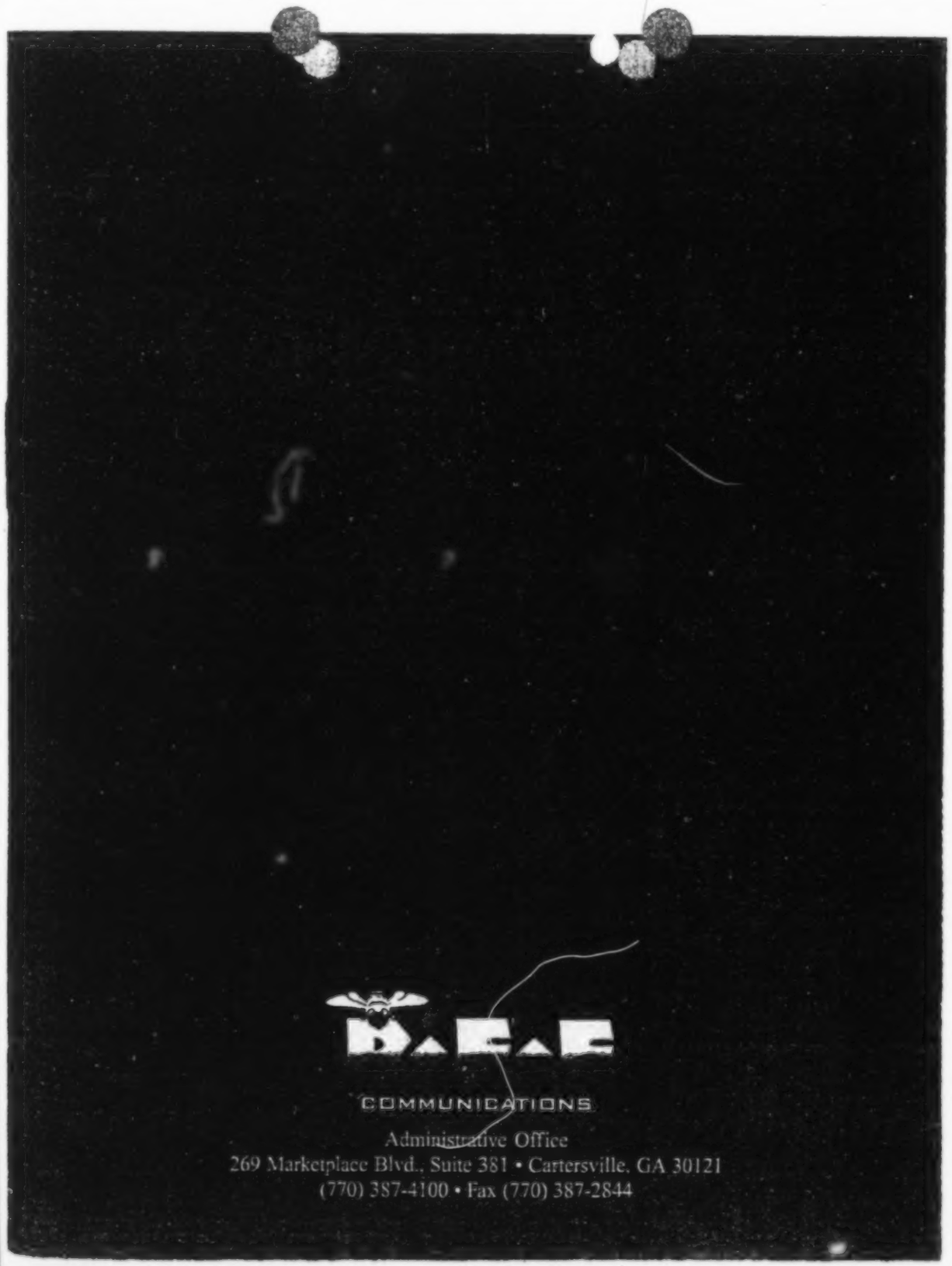
_____
Signature

_____ BEE
Referred By (Print clearly please) Agency

ETS PAYPHONES, INC. • 561 THORNTON ROAD, SUITE K • LITHIA SPRINGS, GA 30122 • (770) 819-1600 • FAX (770) 819-1685

B·E·E
COMMUNICATIONS





B·E·E
COMMUNICATIONS

Administrative Office
269 Marketplace Blvd., Suite 381 • Cartersville, GA 30121
(770) 387-4100 • Fax (770) 387-2844

PLAINTIFF'S EXHIBIT 16

B·E·E COMMUNICATIONS

COCOT Purchase Agreement

CUSTOMER OWNED COIN OPERATED TELEPHONE

448 N. Cedar Bluff Road, Suite 352
Knoxville, TN 37923
1-888-272-4704

INVOICE NUMBER: BC 8382

Sold To: ☐ Individual ☐ Corporation ☐ IRA ☐ J.T.W.R.O.S ☐ Other

Name 1 _____ Social Security/FIN #: ___ - ___ - _____

Name 2 _____ Second SS # (J.T.) ___ - ___ - _____

Address _____ Home Phone (____) _____

City _____ Business Phone (____) _____

State _____ ZIP _____ Fax Number (____) _____

Buyer Elects ☐ Option 1 ☐ Option 2 ☐ Option 3

Ship To:

Name _____

Street Address _____

City, State, ZIP _____

Entered into and agreed upon the _____ day of _____, 19 ____, the purchaser ("Owner") agrees to purchase and B.E.E. Communications, ("Seller") agrees to sell _____ unit(s) of pay telephone(s), hereinafter referred to as "Equipment."

1. Consideration – Cash Payment

   a. In full payment to Seller for the Equipment sold hereunder, Owner shall pay total sum as follows: $6,750 x_____ units = $_____.

   b. This agreement shall serve as a receipt for Owner.

2. Purchaser has fifteen (15) days from the date of this Purchase Agreement to nullify the sale, in which Seller will give full refund.

3. Should for any reason, BEE Communications, not deliver the equipment, the Purchaser will be given a full refund.

4. Bill of Sale and Delivery
   a. As directed by Owner, Seller agrees to deliver the Equipment purchased herein to the address indicated above.
   b. Delivery by Seller shall be considered complete upon delivery of the Equipment to Owner, Owner's Agent or to a suitable security facility as instructed.
   c. Owner agrees to take delivery of installed equipment and location on site.
   d. Upon delivery, Owner shall acquire all rights, title and interest in and to the Equipment purchased.

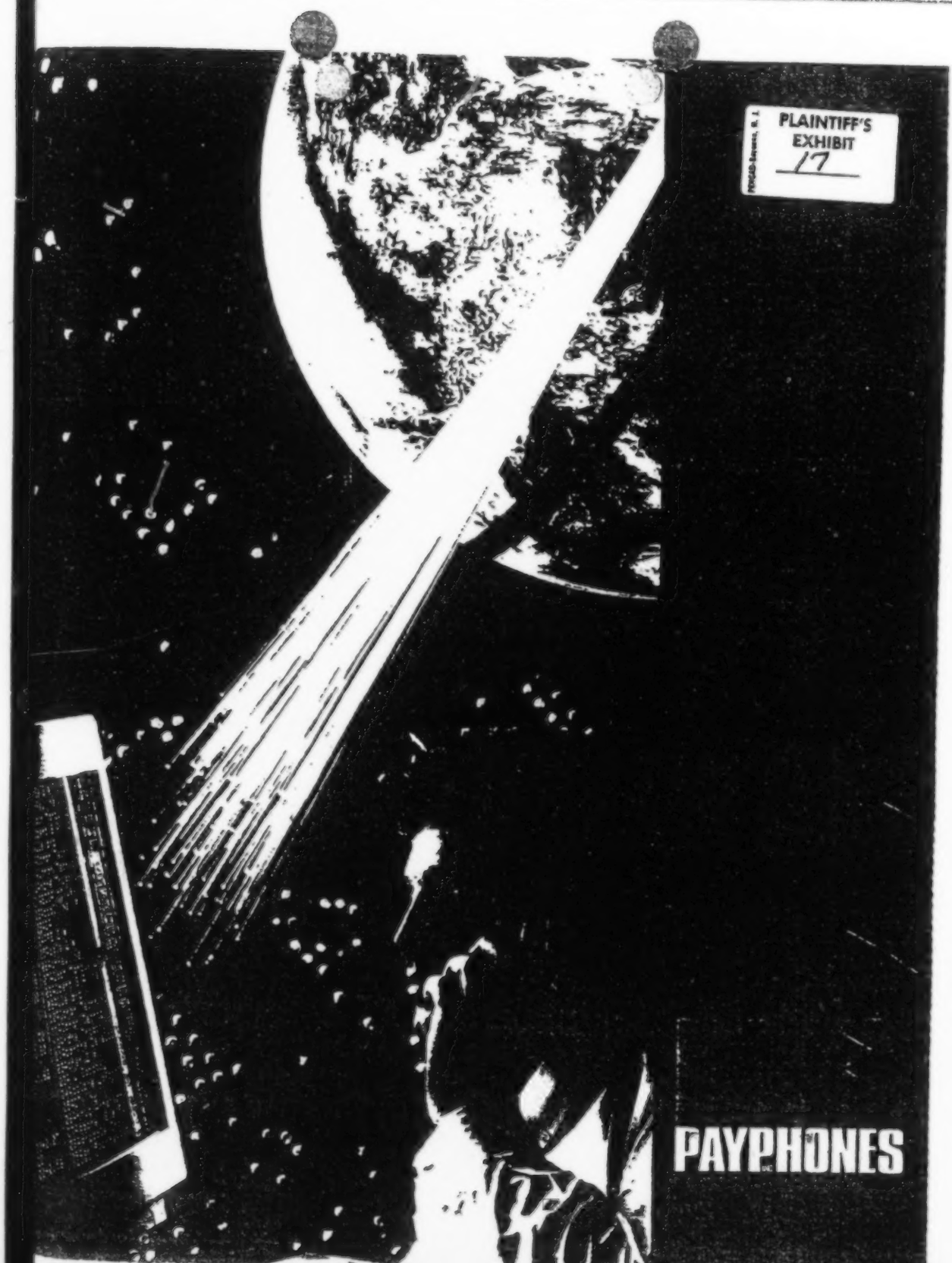
_____ _____
Purchaser's Signature Distributor Signature

_____ _____
Purchaser's Printed Name Distributor's Printed Name

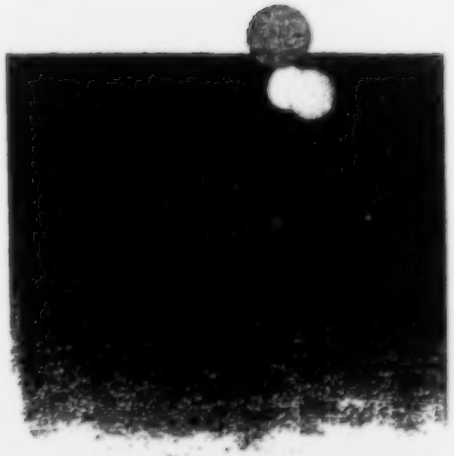
_____ SELLER: BEE COMMUNICATIONS
Signature of J.T.

Pink Copy - Purchaser Yellow Copy - Distributor White Copy - BEE

REV 9-1-98
FORM 101



ETS
PAYPHONES
561 Thornton Road
Lithia Springs, GA 30122
770-819-1600
770-819-1685



ETS
PAYPHONES

The Fast-Paced World of Telecommunications

Today's telecommunications industry provides a seemingly endless capacity for growth and profit. Never before has an industry moved more swiftly, pioneering sophisticated technology that has become the backbone of a thriving global economy and instantaneous communication systems. Telecommunications is the key to doing business in every civilized country in the world. It's a link between friends and families; home and business; from client to client; and between computer networks and database resources around the world.

With all the complex uses of communications technology, it's a wonder that one of the simplest building blocks of the industry; a single kind of telephone equipment that has been a familiar part of western society for decades.

Opportunity doesn't always knock... sometimes it rings

plays such a vital role in meeting everyday communication needs. It's the multi-billion-dollar pay telephone industry that is providing some of today's most exciting business opportunities, as demand continues to grow for this primary communications medium.

The Incomparable Pay Phone

More than two million pay phones are located in airports, restaurants, malls, public facilities, hotels and conference centers, as well as many other familiar places throughout the country. Is there any other means of communication likely to replace the pay phone? While technology advances, opening new channels and devices for communication, there really is no substitute for the pay phone. It is a fundamental and relatively inexpensive link in the chain of worldwide communications and is the medium of choice for telephone calls placed outside the home and place of business.

Pay phones have emerged as an exciting business opportunity in the rapidly evolving telecommunications market—and have already proved to be a reliable means of generating income. In the past, pay phones were operated with little or no profit, much like a service in the public interest. Now, all of that has changed. Deregulation has provided the opportunity for corporate and private ownership, opening the door for profits for individual pay phone owners and operators.

An Emerging Competitive Market

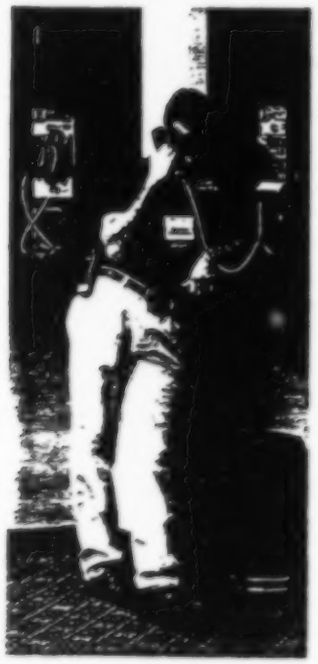
Until the mid '80s, all pay phones were owned and operated by a limited number of large corporations. These corporations controlled the development and manufacturing of pay telephone equipment, the lines, the long distance providers, the local exchange and system of operators, as well as all maintenance and collection of revenues. Without the type of competition found in a free marketplace, service was typically poor, with damaged, inoperative equipment neglected for weeks at a time.

The legislation which led to the deregulation of the telecommunications industry by the Federal Communications Commission (FCC), beginning in 1984, opened the field to competitors in many areas. Additional rulings and legislation resulted in competitors entering the market as manufacturers of sophisticated, technologically advanced communications equipment, and most importantly, the opportunity for private involvement in the pay phone industry, beginning in 198".

Now, more than a decade after deregulation was set into motion, competition has led to the outstanding innovations and sophisticated equipment that make the pay phone industry run more smoothly than ever, boosting profit potential to multi-billion-dollar levels.

ETS manages and maintains phones in busy conference facilities, like the upscale Cobb Galleria Centre just north of Atlanta.

Why Are Pay Phones Ringing with Opportunity?



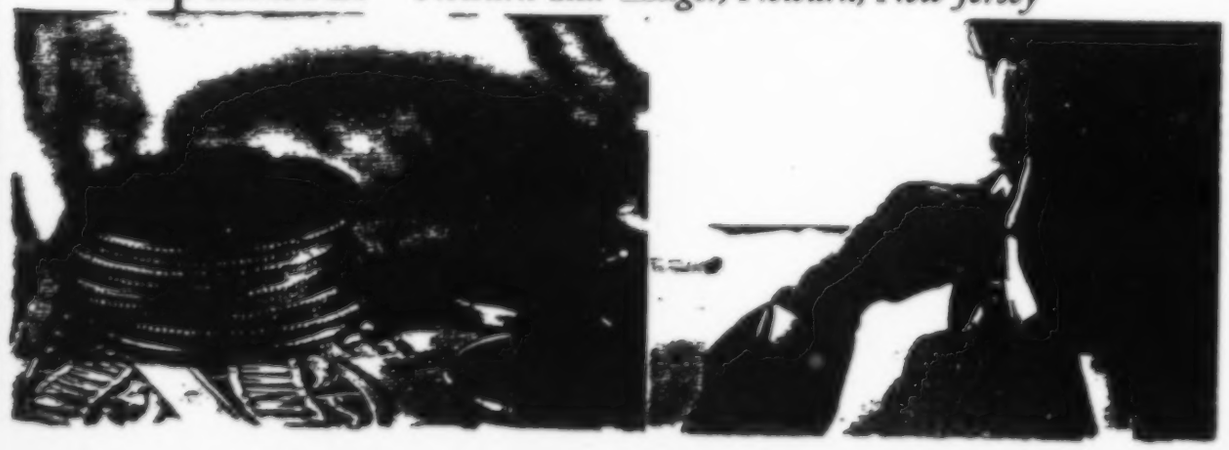
Since private owners entered the field, the pay phone industry has grown into a highly profitable venture, with revenues in excess of $9 billion in 1996 alone. Competing manufacturers have been able to focus on the development of new technologies which promote greater operating efficiencies. With increased efficiency, pay phone profits have grown dramatically, and are expected to continue to escalate, with recent legislation that provides for additional compensation to pay phone owners.

Pay phone ownership offers a unique business environment:

- **It is virtually recession-proof.**
- **It can produce revenue 24 hours a day, 365 days a year.**
- **Pay phones can offer a steady, immediate cash flow.**
- **And, it may provide significant income tax benefits.**

Very few business opportunities can offer the potential for ongoing revenue generation that is available in today's pay telephone industry.

"With continuing deregulation of the telephone industry, those competitive services are **expected to grow** as the access to all public pay phones is expanded." *Newark Star-Ledger, Newark, New Jersey*



The Smart Phone Difference

Independent pay phone owners and operators are changing the landscape of the pay phone industry. Much of the pay phone equipment currently installed is obsolete. Independent pay phone operators, such as ETS Payphones, Inc., who install the most technologically advanced equipment, have a competitive edge over older, larger operators.

The "Smart Phone" is the state-of-the-art telephone equipment of today's pay phone revolution. These phones are designed to "talk" with PC-based systems to manage every function of the pay phone from a remote, centralized location. The Smart Phone equipment installed by ETS is equipped with a micro-processor that incorporates self-diagnostic and reporting functions, with monitoring capabilities from a central location via computer modem. Older equipment does not have these "instantaneous" communication capabilities and must be serviced and managed individually, and usually, in person. Smart Phone technology results in superior "hands-off" operation, unparalleled efficiency and optimum profitability.

Smart Phones not only require less hands-on maintenance, but also can report equipment malfunctions and the number and type of calls being made from each phone. With this type of reporting, it's possible for a pay phone owner to know at all times how each pay phone is performing.

Pay phones must be operational to produce revenue. The longer a pay phone is out of service, the less opportunity exists for income. The monitoring capabilities built into Smart Phones signal the ETS control center when phones are not operating properly. When signaled with a problem, ETS quickly dispatches a maintenance technician. Phones can be returned to proper operating order rapidly, with as little interruption in revenue generation as possible.

All pay phones installed by ETS are equipped with the means to manage the following electronically:

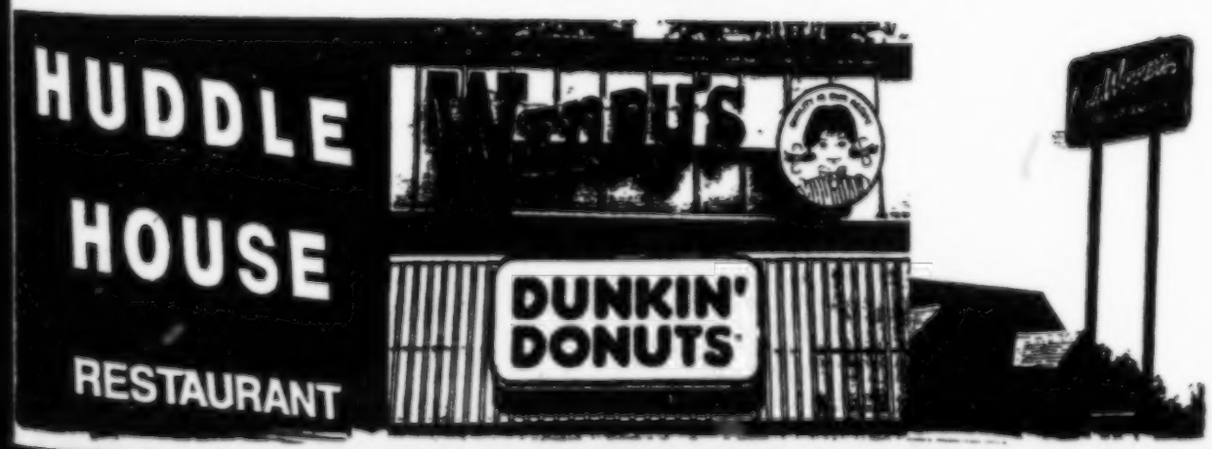
- **The level of coins in the cash box.**
- **Summeries of phone activity.**
- **Processing of credit card and calling card calls.**
- **Telephone vandalism and other damage.**

"There are millions to be made from owning pay phones."

Watch the Profits Add Up

Does it seem that an industry operated with pocket change might have income limitations? Not so! Revenue for 1996, the last year before legislative changes that altered the participation of the Bell Companies in the pay phone industry, topped $9 billion. The 1996 legislation promises even greater revenue, with regulations lifted for the charge for a basic pay phone call and compensation provided for 800 and 888 toll-free calls, as well as other "dial around" methods of payment commonly associated with pay phones.

Centralized monitoring for locations across the U.S. makes ETS a good choice for managing pay phones for national chains.



Why Are Pay Phones So Profitable?

While the revenue and expenses related to a single public pay telephone can vary, a public pay telephone located in a high-traffic or well-frequented location has the potential to provide an owner with substantial cash flow.

Pay phone revenue can be generated in many ways:

Coin Calls: Most calls initiated on pay phones are local calls made with coins. This provides immediate cash revenue for pay phone owners.

Calling Card/Credit Card Revenues: These "coinless" calls are billed to the caller's credit card or phone company calling card. Most card calls are long distance calls.

Collect/Third-Party Billing: Collect calls are also "coinless" calls, but require operator intervention and usually carry a surcharge that is added to the charge for the measured long distance rate.

"Dial Around" Revenues: In the past, toll-free calls to "800" and "888" telephone numbers did not provide revenue for the pay phone owner. Regulations have been changed to provide payment to pay phone owners for each "Dial Around" call.

The chart below demonstrates how independent owners of public pay telephones can profit from calls placed on their telephone equipment:

Incremental Economics of a Medium - Volume Pay Phone

	Monthly	Annually
Revenue - Coin	$200	$2400
Revenue - Non Coin	98	1176
Total Revenues	$298	$3576
Telephone Line	42	504
Site Commission	75	900
Long Distance Charges	17	204
Cost of Revenues	134	1608
Gross Margin	$164	$1968

CAUTION: These figures are only estimates of what may be earned on a medium-volume pay phone. Site commission, line and long distance charges may vary with location of phone.

"An average of **1,500 to 1,700 calls** are made on a pay phone per month, according to AT&T"
Cincinnati Post

ETS Payphones, Inc.—The Pay Phone Experts

ETS Payphones, Inc. has owned and operated public pay telephones since 1992. Growing from a local operation based in Atlanta, Georgia, ETS has expanded to a national firm with equipment and facilities located through the United States. ETS installs only the most technologically advanced Smart Phone equipment, which is monitored 24 hours a day from a central facility. With technicians and maintenance facilities located throughout the country, pay phones can be managed efficiently, with a timely response to every signal.

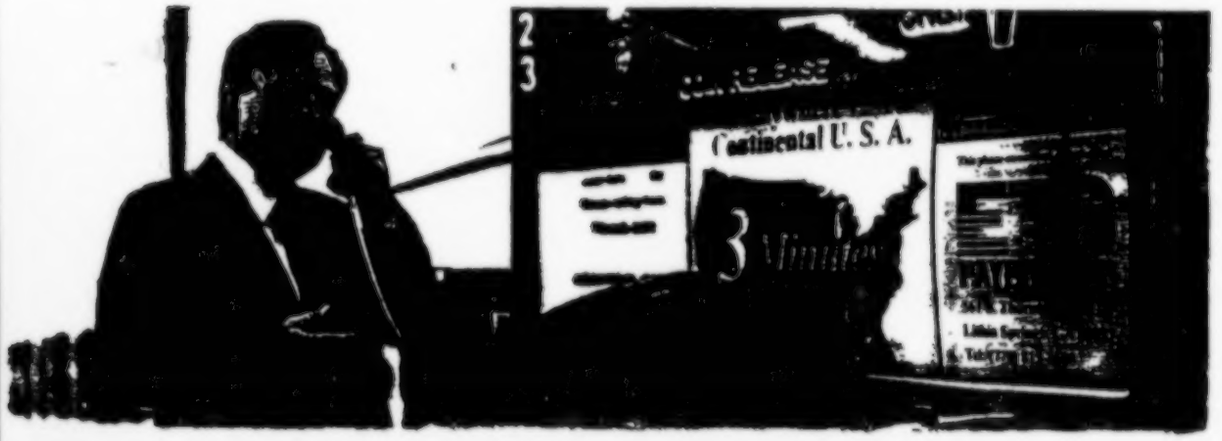
ETS owns and operates pay phones throughout the country and offers a wide range of services that include the management and service of independently owned pay telephone routes. A recent study indicates that independent operators of public pay telephones, such as ETS, can provide a higher level of service while incurring lower costs than the larger, less efficient operators.

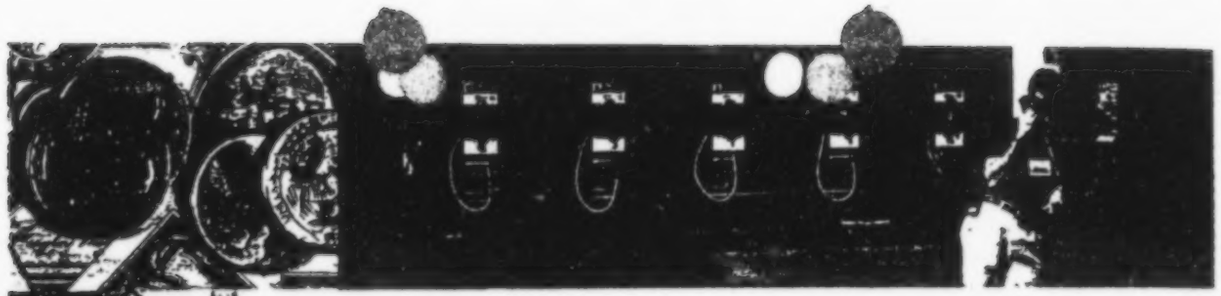
ETS offers the following services:

- Replacement of antiquated equipment in existing locations
- Locating sites suitable for public pay phones
- Securing a local operator service provider
- Securing a long-distance service provider
- Installation of equipment
- Internal pay phone equipment maintenance
- External pay phone equipment maintenance, including cleaning
- 24-hour equipment monitoring of "Smart Phones"
- Coin box collections

The broad base of operations built by ETS Payphones, Inc. crosses many states and governmental boundaries and provides a high quality, efficient management system for pay phone owners from coast to coast. This includes the management of pay phone equipment located in national fast food chains, restaurants, hotels, convenience stores, airports, sports arenas and other facilities that include pay phones on site.

For the pay phone owner, the need to contract individual management agreements for pay phone equipment on a state-by-state or region-by-region basis is eliminated. Both the site owner and pay phone owner can benefit from the experience, operating efficiencies and management expertise provided by ETS Payphones, Inc. Profits are maximized and all reports on pay phone activity are provided from one central location, in a timely manner.



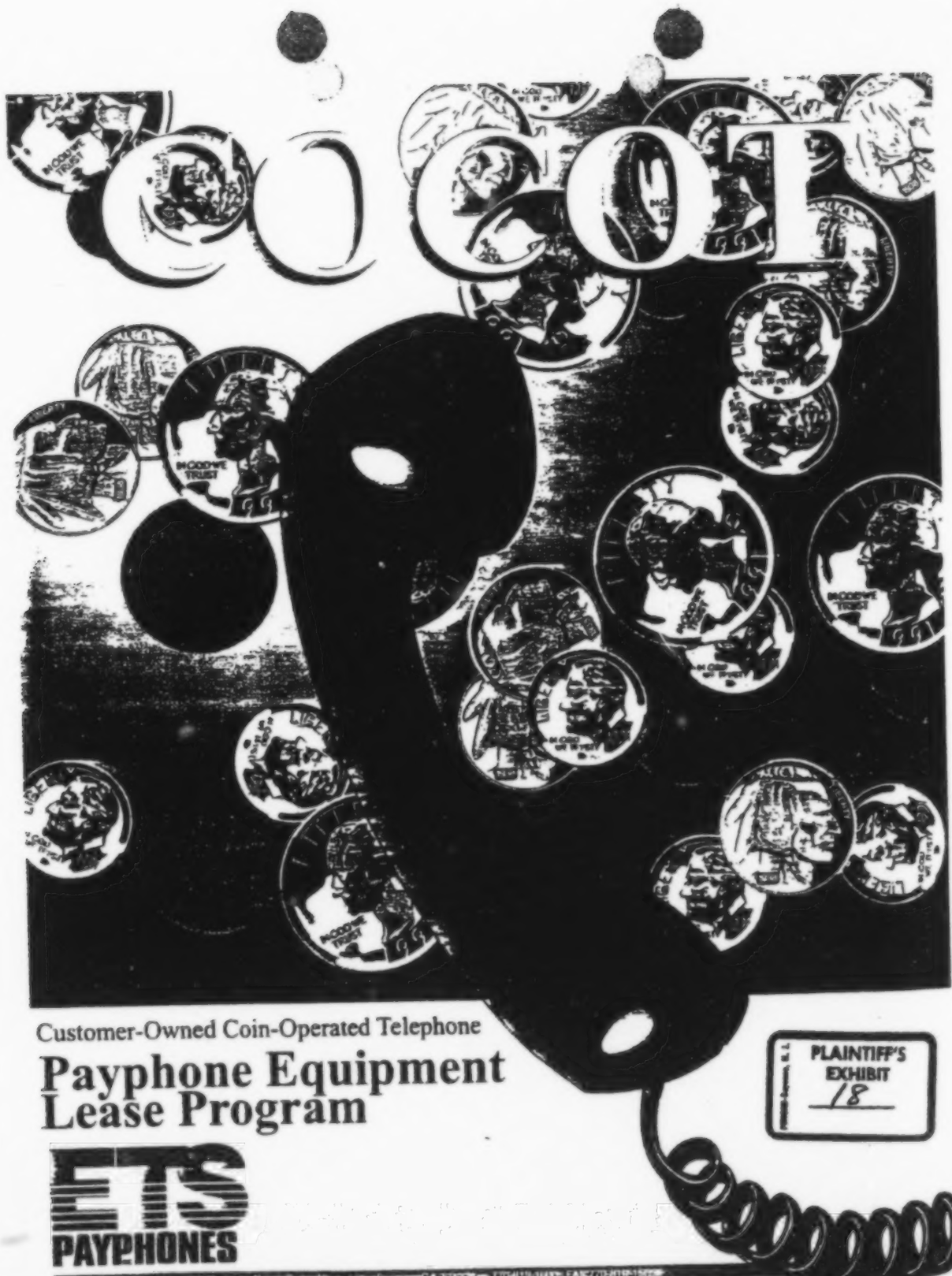


An Opportunity for a Profitable Future

The pay phone industry is primed for a successful and profitable future. Independent owners and operators in the pay phone industry may never again encounter an opportunity with so much potential for growth. ETS Payphones, Inc. offers a superior record of system maintenance, state-of-the-art equipment and management experience. For an opportunity to take part in this multi-billion dollar industry, look to ETS Payphones, Inc. to pave the way to a profitable, efficient pay phone operation.

PAYPHONES

561 Thornton Road
Lithia Springs, GA 30122
770-819-1600
770-819-1685



Customer-Owned Coin-Operated Telephone

Payphone Equipment Lease Program

PLAINTIFF'S EXHIBIT 18

ETS PAYPHONES

BASIC DISCLOSURE DOCUMENT

PRESENTED BY

ETS PAYPHONES, INC.
June 1999

INFORMATION FOR PROSPECTIVE OWNER/LESSORS

STUDY THIS MATERIAL CAREFULLY. WHILE IT CONTAINS SOME INFORMATION REGARDING YOUR LEASE. DO NOT RELY ON IT ENTIRELY. READ ALL OF THE LEASE CAREFULLY, AND TAKE TIME TO DECIDE IF IT IS RIGHT FOR YOU. IF POSSIBLE. SHOW YOUR LEASE TO AN ADVISOR (I.E., A LAWYER, CPA ETC.).

IF YOU FIND ANYTHING IN THESE DOCUMENTS THAT MAY BE WRONG, OR THAT YOU FEEL MAY HAVE BEEN LEFT OUT, YOU SHOULD LET US KNOW IMMEDIATELY.

revised 6/99

1. THE COMPANY

ETS Payphones, Inc. is a closely held Georgia Corporation with headquarters in Atlanta, Georgia. Founded in 1994, ETS owns, leases and services customer owned coin operated telephones (COCOT). Growing from a local area operation, ETS has become a national firm with equipment and facilities located throughout the United States. ETS installs only the most technologically advanced equipment, utilizing "Smart Phone" technology. Smart Phone technology allows ETS to electronically monitor all of its payphone equipment from strategically based technical support centers. ETS payphones are monitored 24 hours a day, and when problems are detected, repair technicians are dispatched promptly through their national service network.

ETS offers a wide range of services that include the management and servicing of independently owned payphone routes. A recent study indicates that independent operators of public payphones, companies like ETS, can provide a higher level of service while incurring lower cost than the larger, less efficient operators.

The broad base of operations built by ETS crosses many state and local government boundaries, and provides a high quality, efficient management system for payphone owners from coast to coast. ETS manages payphones based in locations such as national, regional and local fast food chains, restaurants, hotels, convenience stores, airports, sports arenas, and many other locations where the general public demands the convenience of public payphones. For private payphone owners, the need to enter into multiple agreements with many different payphone service companies is eliminated. Both the site location owner and the payphone owner can benefit from the efficiencies and management expertise provided by ETS. Profits for both are maximized and all reports on payphone activity are provided from one central location, accurately and on time.

ETS offices are located at 561 Thornton Road, Suite K. Lithia Springs, Georgia 30122. The telephone number is 770-819-1600 and the fax number is 770-819-1685. ETS is a member of the Better Business Bureau of Metropolitan Atlanta, and the American Public Communications Council (APPC), the national industry association.

2. MANAGEMENT TEAM

Charles E. Edwards - President and Chief Executive Officer

Mr. Edwards is the founder and also serves as the director for the Company. Mr. Edwards has 30 plus years of experience building successful sales organizations and international marketing and manufacturing firms. Mr. Edwards has spent the last nine years in the telecommunications industry.

Specific to COCOTs, Mr. Edwards has been an owner and operator of private payphones in the Tennessee area. More importantly, Mr. Edwards has devoted the last six years to research in the payphone and telecommunications industry. In addition to his duties with ETS, Mr. Edwards also serves on the Board of Directors of the Georgia Payphone Association.

Kenneth R. Stricklin - Chief of Staff

Mr. Stricklin brings more than 35 years of financial and operations management experience. His background includes six years of public accounting and 16 years of financial management with the Motion Picture Theatre, Television and Radio Station subsidiaries of Fuqua Industries, Inc. His operations

management experience was developed while on the Executive Staff at Rollins, Inc., as Senior Vice President of Atlantic American Corporation, and as President of Georgia Casualty & Surety Company. Just prior to joining IAQ, Inc., he served as Vice President and Chief Operating Officer for Communications Central, Inc., one of the nation's largest privately owned public payphone companies.

Mario R. Commito - Chief Financial Officer

Mr. Commito has over thirty years of experience in financial and accounting management as a Chief Financial Officer and Controller. He has helped numerous start-up companies in quick-growth situations. Mr. Commito's extensive background in acquiring, supervising, and developing high-tech companies has given him the ability to effectively manage accounting systems to enhance profitability. In addition, Mr. Commito is well practiced in audit preparation, negotiating financial arrangements, tax planning and preparation, and budgeting.

Jason Edwards - Chief Operating Officer

Mr. Edwards has 8 ½ solid years of experience in the payphone industry with the past five years with ETS. Mr. Edwards has been involved in virtually every department in the company from sales and customer service to installs and field service. Since Mr. Edwards has been involved with ETS from the time ETS operated only 100 phones, he is greatly prepared to lead the company in its continued growth. During his tenure at ETS, he has recommended and implemented numerous operational changes that have positively impacted the company. Mr. Edwards has worked closely with our New York Operations department and prior to becoming the Chief Operating Officer, served as an Operations Consultant.

M. Larry Ginsburg - Vice President, Special Projects

Mr. Ginsburg is one of the founders of New York City Public Telephone Company, the oldest private payphone company in New York, and one of the oldest in the United States. Mr. Ginsburg is truly a pioneer in independent payphones. Having been involved since 1984, when private payphone ownership was permitted by the Modified Final Judgement (MFJ), signed by Judge Harold Green of the United States Supreme Court, Mr. Ginsburg was the first person to petition the State of New York to legalize private payphones. He installed the first independent payphones in 1985, and established the first independent payphone company in New York City and State. He served as President and Chief Executive Officer of Coinlel Communications, Inc. until 1990. He then served as Chief Operating Officer for Millicom Service Company from 1990 to 1993, and held the same position with New York City Public Telephone Company until 1998 when he joined ETS.

In addition to being a founding Board member of both the Independent Payphone Association of New York, and the Empire State Payphone Association. Mr. Ginsburg has worked closely with members of the City Council of New York and various city officials to formulate and inaugurate new local laws regarding public payphones.

George A. Schmidt - Vice President, Sales

Mr. Schmidt is responsible for all sales activity for ETS. This includes development and implementation of individual strategies as they relate to: Field Sales Representatives and multi-location national, regional and key accounts. Mr. Schmidt has over 21 years of sales and business management experience.

3. BUSINESS EXPERIENCE

ETS began offering services to private payphone owners in 1994. Its principals and management are experienced in the telecommunications and finance industries. This unique combination of experience has enabled the development of a capable and successful business.

4. LITIGATION

Over the past seven years neither ETS nor any of its officers, directors or any members of management have been convicted of any administrative, civil or criminal action alleging a violation of any business opportunity law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property or comparable allegations. No officer, director, or member of management has been convicted of a felony, or pleaded nolo contendere to a felony charge or been convicted of a misdemeanor or pleaded nolo contendere to a misdemeanor charge or has been liable in civil action by final judgment involving any franchise law, securities law, unfair or deceptive practices, misappropriation of property or comparable allegation.

5. BANKRUPTCY

During the past seven years neither ETS nor any of its officers, directors or operations managers have filed bankruptcy or sought any protection from creditors under the U.S. Bankruptcy Act.

6. DESCRIPTION OF OWNER'S OPTIONS

Because the private payphone industry is made up of many small "Mom and Pop" businesses, it is believed that professional operations management is helpful to the owners in eliminating many of the problems related to running their payphone businesses. Therefore, ETS has developed three basic programs which are described below:

OPTION I
Internal Maintenance Program

Option I is presented for the private payphone Owner who wants to be involved in the day to day operation of his payphone/s, but lacks the technical expertise to do so. **Option I** allows the Owner to take full advantage of the income potential of the payphone industry.

The duties of ETS shall be the management of the Owner's payphone for its internal maintenance and repair, and providing 0+ long distance service. When the Owner obtains a Site Location Lease, a copy will be given to ETS to arrange for the establishment of the location within the parameters of the Site Location Lease Agreement. The following actions represent but do not limit the necessary requirements to operate a private payphone.

THE OWNER WILL:

- Obtain "certification" from each respective state Public Utility Commission (PUC) to own and operate a payphone.
- Obtain a signed Site Location Lease Agreement.

- Order and coordinate the installation of the payphone line from the respective telephone company for each payphone. This includes the 1+ long distance calling service.
- Order from your equipment distributor and arrange for the delivery of the payphone, payphone enclosure, pedestal mounting pad, signs, and any other materials or services required to install and operate a payphone at a new site location.
- Collect coin from coin boxes on a regularly scheduled basis and/or if notified by Company that a particular phone has a full box.
- Count, bag, and deposit all collected coins.
- Reconcile long distance calling records and request carrier commission.
- Request and account for dial around compensation from American Public Communications Council (APCC).
- Prepare and mail site location owner commission statement and commission check to arrive no later than the 25th of the month following collection.
- Prepare and respond to all inquiries or reports required by each respective state Public Utility Commission (PUC).
- Pay monthly telephone bills.
- Assume the responsibility for the profit or loss of each payphone.

ETS WILL:

- Install the Owner's payphone at the site location.
- Program the payphone to offer the special "25 Cents Anywhere" program to enhance coin revenue. This enables the caller to make a long distance call to any U. S. destination at any time of the day for 25 cents per minute.
- When feasible, visit the site and survey for requirements to install the phone.
- Download rate information to program the payphone with proper rates for local, long distance, 1-800 calls, and 911 emergency calls.
- Program the payphone for daily polling and "Call Home" feature to determine service requirements.
- Dispatch repair and service technicians when needed.
- Notify Owner when payphone requires collection.
- Prepare a management statistical activity report and mail to Owner on or about the 20th of each month for the preceding month.
- Reconcile all telephone bills and forward to Owner for payment.

OPTION I - "Internal Maintenance" Fees:

- $45 per month per payphone.
- $55 to $65 per month per payphone if installed outside states serviced by ETS. Price quotes will be provided based on location of installation.
- Fees include parts and labor for parts covered under manufacturer's warranty.
- Cost for non-warranty parts and labor will be invoiced monthly.

OPTION II
Turnkey Maintenance Program

Option II is presented for those Owners who would like to be less involved with the day to day operations of the payphone business and who want to take advantage of the income potential on a profit or loss basis.

ETS will manage and maintain the payphone including all internal and external maintenance.

repair and coin collection, and providing 0+ long distance services. The following actions represent, but do not limit the necessary requirements to operate a private payphone.

ETS WILL:

- Obtain a Site Location Lease Agreement.
- Program the payphone to offer the special "25 Cents Anywhere" program to enhance the coin revenue. This enables the caller to make a long distance call to any U.S. destination at any time of the day for only 25 cents per minute.
- Order and coordinate the installation of all payphone lines from the respective telephone company for each payphone. This includes one + long distance calling services.
- Download rate information to program the payphone with proper rates for local calls, long distance calls, 1-800 calls, and 911 emergency calls.
- Program the payphone for daily polling and "Call Home" feature to determine service requirements.
- Perform all service and maintenance as needed and on a scheduled basis. Repairs or parts replacement not covered by normal maintenance will be invoiced as needed.
- Collect, count, bag and deposit all coins:-
- Reconcile 1+ and 0+ long distance commissions on a monthly basis.
- Apply for and collect dial around compensation on a quarterly basis.
- Reconcile and pay all telephone bills.
- Prepare and mail site location owner commission statement and commission check to be received no later than the 25th of the month following collection.
- Prepare and respond to all inquiries or reports required by each respective state Public Utility Commission (PUC).
- Prepare an overall management statistical report for Owner. Report will be mailed to be received on or about the 25th of the following month, and will include all income from coin, long distance, and dial around, and all expenses, including telephone bill, site location owner commissions, monthly service fee and charges for any maintenance and parts not covered by the Turnkey Maintenance Option. It will include a check or invoice for profit or loss, whichever is required.

OWNER WILL:

- Assume the responsibility for the profit or loss for each owned payphone.

OPTION II "Turnkey Maintenance" Fees:

- $75 per month per payphone.
- This fee includes coin collection and accounting, and parts and labor for parts covered by manufacturer's warranty.
- Cost for non-warranty parts and labor will be invoiced monthly.

OPTION III
Payphone Equipment Lease Program

Option III is presented for those Owners who prefer not to be involved in the day to day operations of the payphone business and who want to limit their exposure.

ETS will execute a Lease Agreement with Owner for 60 months. ETS will provide the same quality management services as outlined in **Option II**, and also provide the services listed below.

ETS WILL:

- Obtain Site Location Agreement
- Pay $82 per month lease payment ($984 per year).
- Insure Owner/Lessor's payphone equipment for up to the total replacement cost.
- Relocate payphone to new profitable location if necessary.
- Upon request, purchase Owner/Lessor's payphone equipment and location for the original price paid, with no penalty.
- Upon request, allow Owner/Lessor to take possession of payphone equipment and location with no penalty.

OWNER WILL:

- Hold title to valuable income producing asset.
  Contact an advisor regarding any depreciation and tax advantages.

OPTION III "Payphone Equipment Lease" Fees:
None.

7. INITIAL FUNDS REQUIRED TO BE PAID BY OWNER

ETS is providing a service to the Owner; either **Option I**, an "Internal Maintenance Program", **Option II**, a "Turnkey Maintenance Program", or **Option III**, a "Payphone Equipment Lease Program".

Option I, the "Internal Maintenance Program," requires the first and last payments in advance. The current monthly fee is $45, therefore $90 is the initial cost. Additionally, the Owner's payphones require "Smart Payphone" technology, and must be compatible with Company's maintenance and management "Smart phone" technology, and must be compatible with Company's maintenance and management software. The Owner shall be responsible for the necessary expense for conversion, if required, which is estimated not to exceed $600 per phone. For Company to offer this service, the Owner's payphone must be located within the approved territory schedule. See "Exhibit D."

Option II, the "Turnkey Maintenance Program," requires the first and last payments in advance. The current monthly fee is $75, therefore $150 is the initial cost. As in **Option I**, the Owner's payphones require "smart phone" technology, however, the Company assumes the responsibility if conversion is required. Also, the payphone must be located within the approved area. See "Exhibit D."

Option III, the "Payphone Equipment Lease Program," requires no initial payment.

8. RECURRING FUNDS REQUIRED BY OWNER

Option I, the "Internal Maintenance Program," requires purchaser to submit a monthly maintenance fee in advance on the first of each month.

Option II, the "Turnkey Maintenance Program" requires the monthly maintenance fee be deducted from monthly revenue. In any given month, if the monthly revenue is less than the required monthly maintenance fee, an invoice will be sent to Owner and is due upon receipt.

Option III, the "Payphone Equipment Lease Program" requires no recurring payment.

9. REQUIRED AFFILLIATES

Owners selecting **Option I** or **Option II** as described in this document, are not required to conduct business with any affiliated person or entity of the Company, except when agreement requires services to be performed by the Company. In such case, the Company has the sole authority to provide service with any of its vendors and with the understanding that those services will be provided within the monthly maintenance agreements as described in **Option I** and **Option II**.

Owners selecting **Option III** as described in this document, permits ETS the sole authority to use any of its qualified vendors and suppliers. The Owner has no obligation or requirement to conduct business with anyone.

10. OWNER RELATIONSHIP TO THE COMPANY

The relationship between ETS and Owner is not that of franchiser and franchisee. ETS does not charge franchise fees. ETS merely provides a service and by entering into a service agreement or lease agreement. The Owner does not become an employee, agent, distributor or franchisee of ETS.

11. COMPANY DECLARATION TO THE OWNER

ETS does not receive any kickbacks, incentives or any payments whatsoever from any vendor as a result of the Lease Agreement. ETS will receive its normal revenues from coin collection, long distance calling or dial around compensation and will be totally responsible for all expenses related to operation of the equipment. The Owner will receive a monthly lease payment.

12. FINANCIAL ARRANGEMENTS

ETS does not offer to finance any purchase made by the Owner. ETS will, however, lease the payphone from the Owner/Lessor based on the terms in the Lease Agreement ("Exhibit B").

13. RESTRICTION OF SERVICE AREA

The Owner is restricted to soliciting for locations only in the territories as described in the Approved Territory Schedule ("Exhibit D").

14. OWNER PARTICIPATION REQUIREMENTS

The Owner entering into a maintenance agreement will be required to provide the services as described in "Exhibit E".

15. TERMINATION

Agreement may be terminated at any time as described by the respective agreements.

16. OWNER AND COMPANY PAYPHONES

ETS currently owns or operates approximately 32,000 private payphones in 32 states. ETS has not offered to provide "Internal Maintenance," "Turnkey Maintenance," or "Payphone Equipment Lease Programs" to private owner/operators prior to October, 1994. ETS is not sure how many companies offer these services, nor is it sure of how many small private payphone owner/operators use the service.

17. SITE SELECTION

ETS requires site location owners to be located within approved territories (see "Exhibit D") for maintenance to be provided. This is a requirement for **Option I**, **Option II**, and **Option III**. ETS will not enter into maintenance or lease agreements to provide service to payphone locations outside the approved service areas.

18. TRAINING

It is not believed that training is needed or offered for Owner to participate in any of these services, unless the Owner desires to become totally involved. In this case the Owner may wish to attend a scheduled training class provided by a payphone manufacturer. The class consists of 2 full days in Sarasota, Florida and costs approximately $200 per day.

19. PUBLIC FIGURE

There is no involvement with any public figure by ETS at this time.

20. COMPANY AGENT IN GEORGIA

Company:
ETS Payphones, Inc.
561 Thornton Road, Suite K
Lithia Springs, Georgia 30122
770-819-1600
Attention: Legal Department

GA Agent:
Business Filings, Inc.
2607-D Moody Road, Suite 101
Warner Robbins, Georgia 31088-6118
1-800-981-7183

21. Exhibits

References	Exhibit A
Sample Lease Agreement	Exhibit B
Sample Option To Sell Agreement	Exhibit C
Approved Territory	Exhibit D
Requirements of Owner	Exhibit E
Location of Assigned Phones	Exhibit F

REFERENCES

LEGAL

Friedman & Associates
Attorney Sheldon Friedman
1050 Crown Point Parkway
Suite 1550
Atlanta, Georgia 30338

ACCOUNTING

Grant Thornton
2300 North Tower
235 Peachtree St., NE
Atlanta, Georgia 30303-1499

BUSINESS PRACTICES

Better Business Bureau
P.O. Box 2707 (Zip30301)
100 Edgewood Avenue
Suite 102
Atlanta, Georgia 30303

Dun & Bradstreet Business Information Services
(800) 333-0505
ETS Account Number: 94 868 3024

TRADE ASSOCIATIONS

American Public Communications Council
10306 Eaton Place
Suite 520
Fairfax, Virginia 22030

Florida Public Telephone Association
125 Gadsden Street
Suite 200
Tallahassee, Florida 32301

Exhibit A

REFERENCES

Georgia Payphone Communications Association
631 Seminole Avenue
Atlanta, Georgia 30307-1464

New Jersey Payphone Association
108 Main Street
Oceanpoint, New Jersey 07757

New Jersey Payphone Group
9 Trocha Ave.
Livingston, New Jersey 07039

Tennessee Payphone Association
420 Stable Drive
Franklin, Tennessee 37069

Independent Payphone Assoc. Of New York, Inc.
417 Harwood Building
Scarsdale, New York 10583-4199

Payphone Service Provider Group
2160 Rolling Hills Drive
Morgan Hill, California 95037
Listed under Coin Call/ETS

G/Five Corporation
4554 Caterpillar Road, Suite C
Redding, California 96049
Listed under ETS

Oklahoma Payphone Association
P.O Box 22303
Oklahoma City, Oklahoma 73123

Texas Payphone Association
P.O. Box 476
Austin, Texas 78767

Exhibit A

Exhibit B

Telephone Equipment Lease Agreement
Lease Number: _____

THIS AGREEMENT is made and entered into this ____ day of _____, 1999 by and between ETS Payphones, Inc., a Georgia corporation (hereinafter "LESSEE") and _____ (_____) (hereinafter "LESSOR").

Witnesseth:

WHEREAS, LESSOR, as owner of _____ (_____) unit(s) of the telephone EQUIPMENT described on Exhibit A, attached hereto and by reference made a part hereof (the "EQUIPMENT") desires to lease said EQUIPMENT to LESSEE and LESSEE desires to lease said EQUIPMENT from LESSOR, all upon the terms and subject to the conditions hereinafter set forth.

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for good and valuable consideration, the receipt and sufficiency whereof are hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. **LEASE OF EQUIPMENT.** Subject to the conditions herein, LESSOR hereby leases the EQUIPMENT to LESSEE and LESSEE hereby leases the EQUIPMENT from LESSOR.

2. **TERM.** This lease shall commence (the "Commencement Date") as of the date provided above and shall remain in full force and effect for an Initial Term of sixty (60) months thereafter (the "Initial Term"). Upon the expiration of said Initial Term, this lease shall be automatically renewed, for an additional Renewal Term of sixty (60) months (the "Renewal Term") unless at least ninety (90) days prior to the end of the Initial Term, either party gives written notice to the other that said party elects not to continue during the Renewal Term. The Initial Term and the Renewal Term are hereinafter collectively deemed the "Term" of this lease. The monthly rent payment for the EQUIPMENT during such Renewal Term shall be the same as the existing rate under the Initial Term. Should LESSOR choose to terminate this lease and take possession of the EQUIPMENT and LOCATION prior to the lease expiration, LESSOR may do so with a ninety (90) day written notice.

3. **RENT.** LESSEE shall pay monthly rental to LESSOR for the EQUIPMENT at the rate of _____ Dollars ($_____) per month per unit. The first monthly rental payment shall be due on the Commencement Date. All subsequent monthly rental payments shall be due on the 1st or 15th day of each succeeding calendar month in accordance with the "Commencement Date" through the term hereof.

Note: LESSOR rental checks shall be sent out by U.S. mail and shall be sent on the 1st or 15th day of each month. However, should the 1st or 15th of the month fall on a Saturday or Sunday, the checks shall be sent the following Monday.

Exhibit B

4. **TITLE.** This Agreement creates a lease of the EQUIPMENT. Nothing contained herein shall be deemed or construed as enabling LESSEE to acquire the right, title or interest in the EQUIPMENT or LOCATION, except as set forth in Section 15 and 16 hereof.

5. **NET LEASE.** Except as expressly provided herein, the parties hereto expressly agree to and acknowledge that this is a "Net Lease" requiring LESSEE to bear the entire cost of using the EQUIPMENT and LOCATION through the Term of this lease. LESSEE shall be responsible for, and shall pay all expenses of, insurance, repair, service and maintenance of the EQUIPMENT and of the LOCATION. LESSEE may, at LESSEE's expense, contract with third parties to provide such repair, service and maintenance.

6. **LOCATION.** The location of the EQUIPMENT shall be set forth on Exhibit A. LESSEE shall be responsible for selecting the location for installation of the EQUIPMENT. LESSEE has the right and sole authority to move EQUIPMENT to a new location should the original location prove to be unprofitable or prove to be in a high vandalism area. LESSOR will be notified in the event of site exchange and will receive notification of the address of the new location. In the event that LESSOR terminates the lease prior to the expiration of the Term and elects to retain the EQUIPMENT, LESSEE shall assign the applicable location lease to the LESSOR by a written letter of assignment between the parties; otherwise LESSEE shall retain the rights to the location.

7. **INDEMNIFICATION AND INSURANCE.**

a. LESSEE shall indemnify and hold LESSOR harmless from and against any and all loss, damage, liability and expense (including, without limitation, reasonable attorneys' fees) which LESSOR shall sustain as a result of (i) the loss of or damage to the EQUIPMENT because of fire, theft, collision, lightning, flood, windstorm, or any other casualty at any time during the Term hereof, or (ii) the death of or injury to any person or damage to any property as a result, in whole or in part, of the use or maintenance of the EQUIPMENT at any time during the Term of this lease.

b. LESSEE's obligations pursuant to Section 7a above shall be deemed satisfied if LESSEE obtains and maintains in full force and effect throughout the Term hereof, at the sole cost and expense of LESSEE, a policy or policies of insurance issued by an insurer reasonably satisfactory to LESSOR, with premiums prepaid thereon, insuring LESSEE against the risks and hazards specified in Section 7a (i) hereof with minimum coverage of $100,000 for property damage ($500,000 for the death of or injury to any one person) and $2,000,000 for any one accident or occurrence.

c. LESSEE's failure to obtain the insurance coverage specified in Section 7b hereof shall not affect LESSEE's obligations under this lease. The loss of, damage to or destruction of the EQUIPMENT shall not terminate this lease; nor to the extent that LESSOR is actually compensated by insurance paid for by LESSEE, as herein provided, relieve LESSEE from LESSEE's liability hereunder. Should LESSEE fail to so procure or maintain the insurance required under this Section 7, then LESSOR shall have the option, but not the obligation, to procure or maintain such insurance coverage for the account of LESSEE, and in that event. LESSEE shall reimburse LESSOR within seven (7) days after receipt of any invoice for any payment made therefore by LESSOR. Failure to so reimburse LESSOR shall be deemed a default under the terms of Section 10 hereof.

8. **TAXES AND OTHER CHARGES.** LESSEE shall pay, when due, any and all use taxes, personal property taxes and any and all other taxes which may be imposed by the ownership, possession, use or operation of the EQUIPMENT at any time during the Term hereof or which are levied against or measured by the gross receipts delivered to LESSOR as a result of the payment of rent by LESSEE hereunder.

9. **USE, OPERATION, ALTERATIONS AND ADDITIONS.** The EQUIPMENT shall at all times during the Term hereof be under the sole and absolute control of LESSEE, subject to the rights of LESSOR in the event of a default by LESSEE as provided herein. LESSEE shall comply with any and all laws and regulations applicable to the operation of the EQUIPMENT, and shall be solely responsible for the payment of any and all fines or penalties resulting from its failure to comply therewith. LESSEE shall maintain the EQUIPMENT in good working order at the location identified on Exhibit A, attached hereto, at all times throughout the Term hereof or at any other location where the EQUIPMENT may have been relocated. LESSEE may from time to time add further parts or accessories to the EQUIPMENT, provided any such addition does not materially affect or materially impair the value of the EQUIPMENT. Any such additions shall become the property of the LESSOR.

10. **DEFAULT AND REMEDIES.**

a. **DEFAULT.** The occurrence of any one of the following events shall constitute an event of default by LESSEE:

1. A default by LESSEE in the payment of any amount due hereunder as and when the same shall become due and the continuance of such default for a period of more than twenty (20) days following LESSEE's receipt of written notice of such default requiring the same to be cured; or

2. A default by LESSEE in the performance of any of its material obligations under this lease and the continuance of such default for a period of more than thirty (30) days following LESSEE's receipt of written notice of such default requiring the same to be cured; provided, however, that if more than thirty (30) days are reasonably required in order to cure any such default, then no default shall be deemed to have occurred so long as the curing of such default is commenced by LESSEE within such thirty (30) day period and LESSEE thereafter diligently prosecutes the curing of such default to completion; or

3. Whenever an involuntary petition shall be filed against LESSEE under any bankruptcy or insolvency law or under the reorganization provisions of any law or like import, or a receiver of LESSEE of or for the property of LESSEE shall be appointed without the acquiescence of LESSEE and such situation under this Section 10a-3 shall continue and remain undischarged or unstayed for an aggregate period of thirty (30) days (whether or not consecutive) or shall not be remedied by LESSEE within thirty (30) days; or

4. Whenever LESSEE shall make an assignment of the property of LESSEE for the benefit of creditors, shall file a voluntary petition under any bankruptcy or insolvency law, or whenever any court of competent jurisdiction shall approve a petition filed by LESSEE under the reorganization provisions of the United States Bankruptcy Act or under the provisions of any law or like import; or

5. The abandonment of the EQUIPMENT by LESSEE or the discontinuance of the operation of such EQUIPMENT by LESSEE; or

6. The failure to notify LESSOR of any relocation within sixty (60) days; or

7. The failure of LESSEE to remove within thirty (30) days any mechanics liens on the EQUIPMENT for additional work performed on such EQUIPMENT.

b. **REMEDIES.** Upon the occurrence of an event of default under Section 10a above which is continuing and remains uncured, then LESSOR may, at its option, during the continuance of such event of default:

Exhibit B

1. Terminate this lease by written notice to LESSEE and recover from LESSEE damages incurred by reason of such default, including the reasonable costs of recovering the EQUIPMENT and reasonable attorneys' fees relating thereto, in which event LESSEE shall immediately surrender the EQUIPMENT to LESSOR, and if LESSEE fails to do so, LESSOR may take possession of the EQUIPMENT; and in that event, any rights to the EQUIPMENT that LESSEE may possess pursuant to this lease shall automatically terminate; LESSEE shall have no further right to use of the EQUIPMENT; LESSOR may, without demand or legal process, retake and retain the EQUIPMENT; all rights of LESSEE in and to the location of the installed EQUIPMENT shall be deemed automatically assigned to LESSOR; and LESSEE shall have no further rights to such location whether such rights existed during the Term hereof or arose or were to arise following termination or expiration hereof; or

2. Without terminating this lease, enter upon the location thereof and take possession of the EQUIPMENT and thereupon relet the EQUIPMENT, as LESSEE's agent, at the best price obtainable by reasonable efforts, and in such event, LESSEE shall be liable to LESSOR for any deficiency between (i) the amount of rental due hereunder plus the reasonable cost to LESSOR of recovering and reletting the EQUIPMENT, including reasonable attorneys' fees, and (ii) the rental received by LESSOR from such reletting.

11. **SURRENDER.** Except as set forth herein, upon the expiration or earlier termination of this lease, LESSEE shall return the EQUIPMENT and LOCATION to LESSOR in good operating condition, normal wear and tear excepted.

12. **RIGHT OF INSPECTION.** LESSOR shall have the right at all times throughout the Term hereof to inspect the EQUIPMENT whenever and wherever the same shall be located.

13. **WARRANTIES AND CLAIMS THEREUNDER.** LESSOR makes no warranty or representation, expressed or implied, with respect to the EQUIPMENT; provided, however, that the EQUIPMENT shall be subject to any standard warranty of the manufacturers of such EQUIPMENT or components thereof. LESSOR hereby appoints LESSEE as its agent and attorney-in-fact throughout the Term hereof to assert and enforce, at LESSEE's sole expense, any claims LESSOR may have as owner of the EQUIPMENT against any vendor, manufacturer or supplier with respect thereto.

Exhibit B

14. **ASSIGNMENT.** LESSEE shall have the right to assign or sell any of its rights hereunder. LESSOR shall have the right to sell or assign its rights hereunder, including any or all of LESSOR's right, title and interest in and to the EQUIPMENT and location and the rent reserved herein. In the event of such assignment by LESSOR, the assignee thereof shall thereupon acquire all rights and remedies possessed by or available to LESSOR. Upon receiving proper notice of any such assignment, LESSEE shall thereafter make any and all rental payments as therein directed.

15. **RIGHT OF FIRST REFUSAL.** In the event LESSOR obtains an offer from a third party for the purchase of the EQUIPMENT, then LESSOR shall thereupon provide LESSEE with written notice of the proposed sale and terms thereof. LESSEE shall thereafter have thirty (30) days from the date of its receipt of such notice in which to give written notice to LESSOR of its election to purchase the EQUIPMENT upon the same terms and conditions as the third-party offer. If LESSOR does not receive written notice of such election from LESSEE within such thirty (30) day period, then LESSOR shall be free to sell the EQUIPMENT pursuant to such third-party offer. Should LESSEE notify LESSOR of its election to purchase, then LESSEE shall have one hundred eighty (180) days to close sale from the date of the original notice.

16. **OPTION TO SELL AGREEMENT.** Should LESSOR choose to sell the EQUIPMENT to the LESSEE prior to or at the end of the Term of the lease, then LESSOR shall execute the Option to Sell Agreement attached hereto and by reference made a part hereof as Exhibit B. The terms and conditions of the Option To Sell Agreement shall govern the purchase by the LESSEE of the EQUIPMENT. LESSEE shall have one hundred eighty (180) days from the date of receipt of the original written notice to purchase said EQUIPMENT.

17. **PERSONAL PROPERTY.** The EQUIPMENT is and at all times throughout the Term hereof shall remain personal property, even if all or any portion of the EQUIPMENT becomes affixed or attached in any matter whatsoever to any real property.

18. **ACKNOWLEDGMENT OF DISCRETION.** LESSOR represents and warrants that (a) LESSOR is free to enter into agreements with parties other than LESSEE for the economic exploitation of the EQUIPMENT; (b) LESSOR was not required to enter into this lease as a condition to purchasing the EQUIPMENT; and (c) LESSOR has freely and voluntarily entered into this lease and acknowledges that LESSOR is not entering into or executing this lease in reliance upon any promise, representation or warranty not contained herein.

19. **NOTICES.** Any and all notices required or permitted hereunder shall be notarized, in writing and sent to the intended recipient, addressed to its address set forth below, either by registered or certified mail, return receipt requested, postage prepaid, overnight delivery service, or personal delivery. Each such notarized notice shall be effective (a) if given by mail, as of three (3) business days after such notice or communication is deposited in the United States Mail; (b) if sent for overnight delivery via Federal Express or other reputable national overnight delivery service, one (1) business day after such notice or delivery is entrusted to such service, with recipient signature required; or (c) if personally delivered, when delivered at the address of the intended recipient. Any party may change the address to which notices or other communications hereunder are to be delivered by giving the other party notice in the manner set forth herein. Any notice required to be made within a stated period of time shall be considered timely mailed if deposited before midnight of the last day of the stated period.

Exhibit B

20. **GOVERNING LAW.** This Agreement shall be governed by and construed in accordance with the laws of the State of Georgia.

21. **SPECIFIC PERFORMANCE.** Each party acknowledges and agrees that the other party would be damaged irreparably in the event any of the provisions of this Agreement are not performed in accordance with their specific terms or otherwise are breached. Accordingly, each party agrees that the other party shall be entitled to an injunction or injunctions to prevent breaches of the provisions of this Agreement and to specifically enforce this Agreement and the terms and provisions hereof in any action instituted in any court of the United States or any state thereof having jurisdiction over the parties and the matter, in addition to any other remedy to which it may be entitled, at law or in equity.

22. **DISPUTE RESOLUTION CONTRACT PROVISION.**

a. **Dispute.** Any dispute, controversy, or claim of whatever nature (except an interlocutory hearing for an action for a temporary restraining order, preliminary injunction, or similar equitable relief) asserted by any party against another party arising out of, or relating to, this Agreement or the breach hereof, shall be settled by arbitration, if requested, by any party pursuant to this Section 21. The arbitration shall be conducted by one (1) arbitrator, who shall be appointed pursuant to the Commercial Arbitration Rules of the American Arbitration Association ("AAA"). The arbitration shall be held in Atlanta, Georgia, and shall be conducted in accordance with the Commercial Arbitration Rules of the AAA, except that the rules set forth in this Section 21 shall govern such arbitration to the extent that they conflict with the rules of the AAA.

b. **Notice.** Upon written notice by a party to another party of a request for arbitration hereunder, the parties shall use their best efforts to cause the arbitration to be conducted in an expeditious manner, with such arbitration to be completed within sixty (60) days after selection of an arbitrator. In the arbitration, Georgia law shall govern, except to the extent those laws conflict with the Commercial Arbitration Rules of the AAA and the provisions of this Section 21. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need. All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

Exhibit B

23. **MISCELLANEOUS.** This Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject maner hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked. This Agreement shall not be modified or amended except in writing signed by both parties. This Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Agreement are inserted for convenience only and are not a part of the Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

Check one: _____ Individual _____ Partnership _____ Corporation
_____ Self-Directed IRA _____ Trust _____ Other
_____ Joint Tenancy with Right of Survivorship

LESSEE: ETS Payphones, Inc.

By: Charles E. Edwards
Title: CEO

Address: 561 Thornton Road, Suite K
Lithia Springs, GA 30122

Telephone Number: (770) 819-1600

Date: _____

LESSOR: _____

By: _____
Title: _____

Address: _____

_____

Telephone Number: _____

Date: _____

Exhibit C

OPTION TO SELL AGREEMENT
(Exhibit B to Telephone Equipment Lease Agreement)

THIS AGREEMENT is made and entered into as of the ____ day of _____, 1999, by and between _____ (hereinafter referred to as "LESSOR"), and ETS Payphones, Inc., a Georgia corporation (hereinafter referred to as "LESSEE").

THE PARTIES HERETO ACKNOWLEDGE THAT THIS AGREEMENT INURES TO THE BENEFIT OF LESSOR, AND THAT LESSOR RETAINS SOLE AND COMPLETE DISCRETION IN DETERMINING WHETHER OR NOT TO EXERCISE THE REQUIREMENTS HEREINAFTER SET FORTH.

WITNESSETH:

WHEREAS, LESSOR is the owner of _____ (_____) unit(s) of pay telephone Equipment (the "Equipment") pursuant to that certain PURCHASE AGREEMENT dated _____, 19____, as reflected on Invoice Number _____ related thereto; and

WHEREAS, LESSOR and LESSEE have entered into that certain Lease Agreement (the "Lease Agreement") dated _____, 19____, bearing Lease Number _____, pursuant to which LESSEE has leased the Equipment from LESSOR; and

WHEREAS, pursuant to the Lease Agreement, LESSOR is entitled to require LESSEE to purchase the Equipment prior to or upon termination of the Lease Agreement; and

WHEREAS, the parties have therefore determined that it would be appropriate and in their mutual best interests to enter into this Option to Sell Agreement in order to evidence the rights of LESSOR and the obligations of LESSEE for the sale and purchase of said Equipment; and

WHEREAS, certain terms used herein without definition shall have the meanings ascribed thereto in the Lease Agreement, and this Option to Sell Agreement is made subject to the terms and conditions of said Lease Agreement, all of which are incorporated herein and by reference made a part hereof;

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for other good and valuable consideration, the receipt and sufficiency whereof is hereby acknowledged, the parties agree as follows:

Exhibit C

1. **Agreement to Purchase Equipment.** Subject to the terms and conditions set forth herein, LESSEE agrees to purchase the Equipment from LESSOR if LESSOR elects to sell such Equipment. If LESSOR desires that LESSEE purchase the Equipment prior to or upon expiration of the Lease Agreement, then LESSOR shall give written notice to LESSEE of such requirement. LESSEE shall have 180 days from the date of receipt of written notice to purchase Equipment should LESSOR wish to sell.

2. **Purchase Price.** The price to be paid by LESSEE to LESSOR for such Equipment (the "Purchase Price") shall be _____ Dollars ($_____) per unit. The Purchase Price shall be payable by the LESSEE's delivery of a check for the aggregate amount thereof to LESSOR at LESSOR's address set forth herein.

3. **Termination.** This Option to Sell Agreement shall terminate and be void upon the earlier of: (i) termination of the Lease Agreement; or (ii) the expiration of one hundred and twenty (120) months from execution hereof.

4. **Notices.** All notices required or permitted to be given hereunder shall be notarized , in writing and may be delivered by hand, by nationally recognized private courier, or by United States mail. Notices delivered by mail shall be deemed given three (3) business days after being deposited in the United States mail, postage prepaid, registered or certified mail, return receipt requested. Notarized notices delivered by hand, or by nationally recognized private couriers shall be deemed given on the day of receipt (if such day is a business day or, if such day is not a business day, the next succeeding business day). All notices shall be addressed as follows:

If to LESSOR:

_____
_____
_____

If to LESSEE:

ETS Payphones, Inc.
561 Thornton Road, Suite K
Lithia Springs, GA 30122

and/or to such other respective addresses as may be designated by notice given in accordance with the provisions of this Section 4.

5. **Governing Law.** This Option to Sell Agreement shall be governed by and construed in accordance with the laws of the State of Georgia.

Exhibit C

6. **Construction.** The parties have participated jointly in the negotiation of this Option to Sell Agreement. In the event an ambiguity or question of intent or interpretation arises, this Option to Sell Agreement shall be construed as if drafted jointly by the parties and no presumption or burden of proof shall arise favoring or disfavoring any party by virtue of the authorship of any of the provisions of this Option to Sell Agreement. Any reference to any federal, state, local or foreign statute or law shall be deemed also to refer to all rules and regulations promulgated thereunder, unless the context requires otherwise.

7. **Dispute Resolution Contract Provision.**

a. **Dispute.** Any dispute, controversy, or claim of whatever nature (except an interlocutory hearing for an action for a temporary restraining order, preliminary injunction, or similar equitable relief) asserted by any party against another party arising out of, or relating to, this Option to Sell Agreement or the breach hereof, shall be settled by arbitration, if requested, by any party pursuant to this Section 7. The arbitration shall be conducted by one (1) arbitrator, who shall be appointed pursuant to the Commercial Arbitration Rules of the American Arbitration Association ("AAA"). The arbitration shall be held in Atlanta, Georgia, and shall be conducted in accordance with the Commercial Arbitration Rules of the AAA, except that the rules set forth in this Section 7 shall govern such arbitration to the extent that they conflict with the rules of the AAA.

b. **Notice.** Upon written notice by a party to another party of a request by arbitration hereunder, the parties shall use their best efforts to cause the arbitration to be conducted in an expeditious manner, with such arbitration to be completed within sixty (60) days after selection of an arbitrator. In the arbitration, Georgia law shall govern, except to the extent those laws conflict with the Commercial Arbitration Rules of the AAA and the provisions of this Section 7. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need. All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

8. **Miscellaneous.** This Option to Sell Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Option to Sell Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Option to Sell Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Option to Sell Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject matter hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked.

Exhibit C

This Option to Sell Agreement shall not be modified or amended except in writing signed by both parties. This Option to Sell Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Option to Sell Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Option to Sell Agreement are inserted for convenience only and are not a part of the Option to Sell Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

LESSEE: ETS Payphones, Inc.

By: Charles E. Edwards
Title: CEO

LESSOR: _____

By: _____
Title: _____

ETS Payphones, Inc.
Approved Territory Schedule
February 1, 1999

As of the above date, the following are the only approved states in which ETS will offer the Maintenance Program:

Ohio	North Carolina	Louisiana	Mississippi
Arkansas	Alabama	South Carolina	Maryland
Pennsylvania	Texas	California	West Virginia
Oklahoma	Indiana	Georgia	Tennessee
Florida	Virginia	New York	New Jersey
Kentucky	Arizona	Colorado	Illinois
Iowa	Kansas	Michigan	Minnesota
Missouri	Nebraska	New Mexico	Wisconsin

and the Virgin Islands and Mexico

Exhibit D

ETS Payphones, Inc.

Items required to be performed by Owner if Owner selects the ETS Maintenance Program:

1. Location Lease	*Signed by owner of location*
2. Site Survey	*Completed to determine where phone should be located*
3. Letter of Agency	*Signed by owner of location*
4. Coin Revenue Collection	*Optional – may enter Maintenance Agreement*
5. External Maintenance	*General appearance*

Exhibit E

The Equipment

The equipment described herein constitutes _____ ( )unit(s) of operating payphone stations.

Unit 1
Location: _____
_____
_____
_____
Serial No. _____

Unit 5
Location: _____
_____
_____
_____
Serial No. _____

Unit 2
Location: _____
_____
_____
_____
Serial No. _____

Unit 6
Location: _____
_____
_____
_____
Serial No. _____

Unit 3
Location: _____
_____
_____
_____
Serial No. _____

Unit 7
Location: _____
_____
_____
_____
Serial No. _____

Unit 4
Location: _____
_____
_____
_____
Serial No. _____

Unit 8
Location: _____
_____
_____
_____
Serial No. _____

Exhibit F

561 Thornton Rd • Suite K • Lithia Springs GA 30122
(770) 819-1600 • FAX (770) 319-9233
www.etspayphones.com

(15)

Supreme Court, U.S.
FILED
JUN 26 2003
OFFICE OF THE CLERK

No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

JOINT APPENDIX
(VOLUME II)

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PETITION FOR WRIT OF CERTIORARI FILED: Feb. 13, 2003
CERTIORARI GRANTED: Apr. 21, 2003

137 pp

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[PLAINTIFF'S EXHIBIT 20]

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

File No. A-02502

IN THE MATTER OF ETS PAYPHONES, INC.

HEARING

TRANSCRIPT

APPEARANCES:

On behalf of the Securities and Exchange Commission

BARRY LAKAS, Accountant
ROBET LOUGH, Attorney
JAMES LONG, Attorney
Enforcement Division
Securities and Exchange Commission
Suite 1000, 3475 Lenox Road
Atlanta, Georgia 30326

On behalf of the Witness

W. SCOTT SORRELS, Attorney
WILLIAM B. SHEARER, JR., Attorney
POWELL, GOLDSTEIN, FRAZER & MURPHY
191 Peachtree Street, N.E.
Atlanta, Georgia 30303

* * * * *

[3]

Whereupon,

CHARLES E. EDWARDS

appeared as a witness herein, and having been duly sworn, was examined and testified as follows:

EXAMINATION

BY MR. LAKAS:

* * * * *

[7]

Q. Have you ever testified in an investigation by the Commission or its staff or any other federal agency, any state agency, any stock exchange or the NASD?

A. Only an informal investigation here at this office.

Q. When was that?

A. 1995.

Q. Was it an investigation at the time?

MR. SORRELS: I don't think that was testimony. I think it was an interview that Larry Grant was involved in.

BY MR. LAKAS:

Q. Did he call you in or did you contact him for information?

A. No, he called us in.

Q. What became of that?

A. There was no action per se. He did make two recommendations to us which we fully complied with. One was to get out—at that time, I was in both marketing and leasing and he told me to either get out of leasing or marketing and to give more control to our phone owner, which we in fact did, where they can take it back at any time.

Q. Was there a court reporter at this?

A. No, sir, just my attorney and Mr. Grant.

Q. And it was related to ETS Payphones?

A. Yes, sir.

* * * * *

[13]

Q. Okay. So you started ETS in what year?

A. Six years ago this month. So that would be 1994.

Q. 1994?

A. Right.

Q. Now you said something about Inter-Met?

A. Inter-Net was a company I had—that I started when I left Global. It sold—we were a switchless reseller of long distance and prepaid calling cards. That's how ETS started. We were selling payphones through that company also. When Mr. Grant investigated us, Inter-Net was selling the payphones and ETS was the payphone company side.

Q. I'm sorry, Inter-Net was marketing—selling the payphones?

A. Yes, sir.

Q. What was ETS doing?

A. They were the payphone company.

Q. Oh, okay. They were actually supplying the payphones?

A. Yes, and managing the payphones.

* * * * *

[16]

Q. Okay. What's your financial—do you have more than five percent stock ownership in any company right now?

A. Yes, sir.

Q. What would that be?

A. ETS. Twin Leaf, Inc.

MR. SORRELS: Just any company, Barry, or public companies?

MR. LAKAS: Any company. Well this asks for five percent stock ownership, but any financial participation. I guess he means a private company. If it's a corporation, he probably owned the stock anyway.

THE WITNESS: Right.

BY MR. LAKAS:

Q. So that's it, ETS and Twin Leaf, Inc.?

A. That I'm directly ownership in, yes. I now have an LLC that I have ownership in called Pleasant Hills.

Q. Anything else?

A. No, sir.

Q. What does Twin Leaf, Inc. do?

A. It's a holding company for a number of businesses.

Q. And what type of businesses are they in?

A. Mainly telecommunications and interior duct work cleaning.

Q. Where is it located?

A. Twin Leaf?

[17]

Q. Yeah.

A. At my address.

Q. Home or business?

A. Business address.

Q. How many employees does it have?

A. I think we have about eight or nine.

Q. It's a holding company in telecommunications and does duct cleaning?

A. Yeah, one of the subsidiaries does, yes, sir.

Q. Now what type of telecommunications does it do?

A. It has a company called Legends Communications, which is a full IXC carrier such as AT&T, MCI or Sprint. It's certified in 49 states for long distance and prepaid calling cards, and is certified as a CLEC in three states, also.

Q. Is it affiliated with ETS in any way?

A. Yes. It carries ETS' zero plus—I mean one plus traffic and prepaid calling card traffic.

Q. What about Pleasant Hills, where is that located?

A. In Duluth.

Q. The same address?

A. No, sir, it's—I don't know the exact—well, I'll back up on that. It would be—the official address

would be the same as Twin Leaf. We have a building, that's what that is.

[18]

Q. It's in the same building as the Oakbrook Parkway?

A. No, sir.

Q. Do you have a separate—

A. It's a separate building.

Q. A separate building, okay. Oh, I'm sorry, Twin Leaf and Pleasant Hill are in the same building?

A. Yes, sir.

Q. And what's their address?

A. The one I looked in my pocket and gave you.

Q. I guess I'm a little lost. I thought you said ETS was at Oakbrook Parkway.

A. No, sir, no, sir. ETS is at 1490 West Fork Drive. I'm not an ETS employee per se.

Q. Okay. So when I asked for your business address—what's Oakbrook Parkway?

A. That's where Twin Leaf—and that's the company I work for, and that's where my office is at.

Q. Okay. So what's your position with ETS?

A. I am the CEO.

Q. Okay. But where is most of your time spent?

A. It's about 50/50 in ETS' address, which is in Lithia Springs, Georgia and the Oakbrook office.

Q. Okay. Now I've got you. What does Pleasant Hills do?

A. It only owns the building.

[19]

Q. Okay. But that's the LLC?

A. Yes, sir.

Q. Are you doing that for tax purposes?

A. For an investment.

* * * * *

[30]

Q. While I'm on that train of thought, why don't we go into—I still want to know how you got into this. But while we're on this subject, ETS of today, how many employees do you have?

A. ETS today, we have a little over 400 employees. We operate out of 28 offices in the United States. We have phones in 38 states. We have one in Canada and we're in the Virgin Islands.

* * * * *

[31]

Q. Can you describe the corporate structure now? You say you have a department that locates phones?

A. We are the—either the second or third largest payphone company in the United States today. We're the largest independently owned. The other two in there some place—the largest one is a public company and there's one pretty close to our size that's a public company. We have a—I'm the president and CEO of the company. I have a chief operating officer, a—

Q. Who is the chief operating officer?

A. My son Jason Edwards. I have a CFO, Walter Kadalka. I have legal counsel, John Wagner.

Q. He's in-house legal counsel?

A. Yes, sir. And they work mainly on location disputes and acquisition contracts and all. I'm trying to remember what else that reports direct to me. I have the Leasing Department, which is Mary Spencer. That would be the four departments that report direct to me.

Q. The Leasing Department?

A. They work direct with the phone owners and the leasing and all. We've got, I think, 12 or 13 people that work in that department.

[32]

Q. The locator group, how many people do you have in there?

A. The locator is the marketing group, which would be under operations. We have—I would say nationwide probably 25-30.

Q. So their business is just—their role is to just go out and find payphone locations?

A. Right. Well, I've got one portion of them that do nothing but work with convenience store chains. I have two gentlemen that do that that are employees, and one subcontractor, because we have focused on convenience stores because of all the changes that's happened in our industry. Then the other sales people, out of all the different operations, their job is to find new locations for our phones that are not profitable so we can put them in a new location, hopefully to make them more profitable. And we try to roll 10 percent of our phones each year, the bottom 10 percent.

Q. Do these locator people report to your son who is the chief operating officer?

A. Right.

Q. Okay, let's go back. You say in 1994 and 1995 you basically were just purchasing payphones. You say you started going into I guess this—what do you call it, the leasing program in 1996?

A. 1996.

[33]

Q. How did all of that start?

A. Well, I had looked at ways to get into market payphones. Back then, you could not go and knock on the bank and borrow money to start a payphone company because they wouldn't loan any money on an outside piece of equipment that's hung outside. And so we looked at this as a method where we could have equipment that we could lease and build a payphone company with the ultimate goal of owning all the equipment ourselves.

Q. Who came up with this concept?

A. I did.

Q. Did you hear about it from any other company doing it?

A. I had an acquaintance in Tennessee that told me about a company that had done it.

Q. A payphone company?

A. I don't know—they were a marketing company. I don't know whether they were a payphone company or not. They were marketing payphones, but I don't know whether they were a payphone company themselves.

Q. They were marketing payphones. When you say marketing, does that mean selling there?

A. Yes, sir, selling payphones.

Q. What was the name of that company?

A. I believe it was Amtel. I'm not for sure on that.

[34]

Q. So go into your concept. What was your concept? You say you couldn't get loans from the bank—in other words, you wanted financing to purchase a lot of payphones, is that correct?

A. I guess you could say it that way. I wanted payphones is the ultimate goal I wanted because it was a very profitable business at that time. Your coins was very good, your long distance was extremely good. This was before the days of the 1-800 dial-around and all the other changes that's happened. We looked at a method to do that equipment and be able to sell the equipment to individuals and then lease the equipment from them on a lease payment.

Q. Did you try—did you approach any banks before you—

A. I talked to a couple of banks, yes, sir.

Q. And they said no financing?

A. On the payphones, none. Now since that time there has been a couple of banks that have loaned money on payphones.

Q. So what was your initial idea, just sell these payphones to individuals?

A. Inter-Net sales people sold the payphones to individuals, and ETS, if they chose to, leased them from them or they serviced them for them.

Q. So you came up with this concept of leasing even [35] before you sold the first payphone to any individuals or corporations or investors?

A. Yes.

Q. Okay. In 1996, approximately how many payphones did—you say it was Inter-Net?

A. Inter-Net had sold approximately 220 payphones at that time.

Q. That was in '94 and '95?

A. Correct.

Q. How about when you came up with this concept in '96?

A. No, the concept, I came up with in '94.

Q. Oh, the leasing of the payphones?

A. Yes, but I didn't really take off with it—well actually, we did our first lease in 1995, because we are six years—in '94, because we did our first lease in October 1994.

* * * * *

[36]

Q. And then in 1995 when I had the investigation with Mr. Grant, that's when he said for me—you know, suggested we either get out of marketing or get out of leasing. So we chose to get totally out of marketing. That's when we went to independent marketing groups away from Inter-Net or ETS or anybody.

Q. Okay. So ETS was actually selling payphones, though?

A. No, sir.

Q. Well, I mean in '94 and '95 before you spoke with Mr. Grant.

A. No, ETS has never sold a payphone. Inter-Net sold [37] the payphones.

Q. Okay. Inter-Net sold the payphones.

A. And ETS leased the payphones.

Q. Okay. Well, let's go into—did you come up with the concept of a person who purchases a payphone can either manage the payphone itself, have limited management or do the lease program? Did you come up with that concept?

A. Yes, sir.

Q. Okay. Inter-Net sells the payphones. Did they basically just say that ETS was the sole entity that would lease the payphones?

A. At that time we were the sole entity that would lease the payphone. Now they could choose to put it up themselves and manage it themselves if they wanted to.

Q. Of this initial 220 people, did they all go for this leasing program? Did they all subscribe to the leasing program?

A. I'm trying to remember when my first option—at that time we only had two options, and that was the option of buying a phone and putting it in yourself. I think in the first two years we did have two people that bought that way. But then—and the 220 would be the ones that were leased phones.

Q. Okay. Now the marketing tools that you used, what was told to the individuals or investors who purchased a [38] payphone?

A. Now you're talking about which time frame?

Q. '94 and '95.

A. They were told about the industry. They were given the option what to do with their payphone. If they leased it, they got a $75 a month lease payment that was for five years, and then at that time there was an option to renew it for another five years.

Q. Were they told at that time that at the end of five years they could get their money back for the purchase of the payphone?

A. Yes, sir. They had the option to sell the payphone back to us if they chose, or they could keep it themselves if they chose.

Q. At the end of five years?

A. Yeah—well they could get their phone any time they wanted.

Q. They could also get their money back any time they wanted?

A. Well when Mr.—after my interview with Mr. Grant, that's when we basically put in the fact that they could request to sell us the phone at any time with no penalty whatsoever. We had a 180-day window in which to liquidate the payphone.

Q. And that would be for the full cost of what they [39] purchased the payphone for?

A. Correct.

Q. And what were they renting for in 1994 and '95?

A. They were at 4,500 and 5,000.

Q. And you said you were purchasing your payphones through—where were you purchasing the payphones from?

A. Well Johnny was actually purchasing the payphones. They were either coming out of Becktel or—

Q. Becktel or Atlantic Marketing?

A. Right—North Atlantic Marketing.

Q. Oh, Atlanta Marketing?

A. No, North Atlantic Marketing.

Q. North Atlantic Marketing?

A. Yes, sir.

Q. Okay. And how much were you paying for the payphones themselves, $3,000 approximately?

A. Correct. I think we did our first acquisition of payphones in—we bought a payphone company in Daytona Beach I believe in—it was either '95 or '96 we bought 47 payphones there. It had to be in '95 because Johnny was still servicing the payphones.

Q. I guess what I'm curious about is, it cost you $3,000 approximately to put a payphone at a certain site.

A. Correct.

Q. How could you promise the full amount back?

[40]

A. Well the payphone and location backs up every lease. The equipment with the income stream is the value they've got there. That backs up every lease,

because some phones based on the income stream is worth a lot more than what the people paid for them.

Q. Yeah, but some are probably worth less, aren't they?

A. I would say yes.

Q. I would think of a phone as a depreciating—I mean, the thing still needs—what is the life of a phone?

A. Fifteen years.

Q. Those things could last 15 years?

A. Yes, sir.

Q. What about new technology? I thought things come out, like smart phones?

A. We continually upgrade them. We started with smart phones from the very first, but they are continuously upgraded.

Q. So phones at those locations are continually being improved?

A. Oh, yes, sir, absolutely, because every time we have—you see, when area code changes happen and all of that, we have to change the chips. We have to upgrade the boards and everything so they properly work. We've put electronic coin mechanisms in our phone since that time, [41] which is a $230 charge, but it cuts our service down by about 80 percent on coin jams and all. We've got everything you can put in a payphone on our payphones.

Q. Well then what do you do if someone does sell the payphone site site? Do you resell it?

MR. SORRELS: I'm sorry, will you—

THE WITNESS: I don't follow you.

BY MR. LAKAS:

Q. Will say someone—say I'm an investor and I have my payphone and at the end of four years—or even at the end of five years I want to sell it back to you, and you pay me back. You give me my 4 or $5,000 back. Okay, you give me the 4 or 5,000 back, what do you do with that payphone site? Do you resell it?

A. We put it back in our inventory and the odds are it would be resold, yes, sir, but it would be upgraded at that time.

Q. It it was profitable, would your company keep it?

A. Yes, sir. Well, no, the phones we own—we own phones naturally, but we own—so we wouldn't be pointed at and said you cherry picked and kept all the best phones. We have a database, all of our phones, where they be new install, an acquisition, replacement, whatever goes into that database. We own everything that's not assigned to a lease and what we own this month we won't own next month. But [42] nobody can ever say I've ever cherry picked the phones or gave somebody a better choice because a computer totally assigns the pay phones.

Q. Well getting back to one of my original question, has everyone elected to use the lease option?

A. No, sir. We've got people that's done all three options. Now the majority of them do a lease option, yes, sir.

Q. Now what's the—of the payphones sold between 1994 and 2,000, what is the percentage that used the lease option?

A. Ninty-nine percent.

Q. Ninty-nine percent?

A. (Witness nods.)

Q. Let's go into why you went to the marketing companies.

A. Mr. Larry Grant suggested that, and so I—when I sat down with Mr. Grant, I said if I'm doing anything wrong, please tell me and I'll change. And so the two suggestions he suggested, we immediately went back and did it. The first independent marketing group we had was Bee Communiations out of Cartersville. And from that point on, Inter-Net no longer sold pay phones. Bee was originally the exclusive people that we bought payphones—or leased payphones from, I should say.

Q. Did you—well who went to that meeting with Mr. Grant?

[43]

A. Myself and Shelly Friedman, an attorney.

Q. And what firm is he with?

A. Freidman and—

MR. SORRELS: Associates, I think.

THE WITNESS: Friedman & Associates?

MR. SORRELS: I think that's right.

BY MR. LAKAS:

Q. Okay, now you say Bee Communications was your first distributor?

A. Yes, sir.

Q. Were you instrumental in helping form Bee Communications?

A. No, sir. Instrumental—I offered her—I told her if she would set it up, I would lease phones from her. In that instance, I was. But she said—it was a lady, Beverly Slater, that set it up.

Q. Did you know Beverly Slater?

A. Yes. She had been a marketer for ETS. I don't mean ETS, I'm sorry, for Inter-Net.

Q. What about—

A. As a matter of fact, her sale is what generated the investigation by you guys, the SEC.

Q. Who is Jim Jordan?

[44]

A. Jim now owns Bee Communications. BCI, he calls it. He bought Ms. Slater out.

Q. Did you know Mr. Jordan before he bought Beverly Slater out?

A. Yes, sir.

Q. And where did you know him before that?

A. I met him initially through Inter-Net. He was the sales manager for a long distance marketing company out of Vancouver, Canada and we had talked at one time about merging with that company. That's where I met Mr. Jordan, and then we became friends.

Q. So did you approach Beverly about purchasing Bee, or did you—did you have anything to do with Beverly and Jim Jordan meeting?

A. They met because of me, yes, but he had met her prior to them talking about buying her marketing group.

Q. What is Hayes Communication? I believe it's Hayes.

A. Yes. They are a marketing group out of St. Pete.

Q. Getting back to Bee. Does Bee sell—or does Bee recommend ETS exclusively?

A. I don't know that, no, sir. They—I—no, I don't know. I know they sell other products.

Q. What is your affiliation or relationship with Hayes?

[45]

A. They're an independent marketing group, also.

Q. And who owns Hayes?

A. Curtis Hayes.

Q. Did you have any prior relationship with Mr. Hayes?

A. I met him—he was a marketer for Bee and that's where I met him.

Q. So Bee was formed in approximately 1996?

A. Yes, sir.

Q. How about Hayes?

A. I think Hayes has been about—it'd be around '97. I think it had been a little over three years.

Q. How about National Communications?

A. Yes, they're an independent marketing group.

Q. Who owns that one?

A. Tom Murray out of Boca Raton.

Q. They're also in Florida?

A. Yes, sir.

Q. Do you know—what's his name, Tom Berry?

A. Murray, M-u-r-r-a-y. He came out of the Bee organization. As a matter of fact, he came out of Bee and Hayes came out of his group.

Q. So these entities sell payphones and then they recommend that ETS lease—they recommend that the individuals that purchase these payphones, that they lease [46] them back to ETS, your company, is that correct?

A. I don't know whether they recommend them, I know they give them the option and if they have an interest, then those people contact us and we send them the information, because none of the agents represent ETS, period.

Q. Does ETS sell payphones also?

A. No, sir.

Q. Well, from what it's going to show later, it does look like ETS has some payphones. I have seen a sales brochure for ETS.

A. But that's for getting locations.

Q. Getting locations.

A. Correct.

Q. In other words, that's the convenience stores or—

A. Right, the mom and pop. When the information is requested from a prospective pay phone owner, they fax us and ask for information on ETS, in that packet we send out an ETS brochure and a sample copy of the lease. But it's a generic brochure.

Q. How many payphones does ETS have under management at the current time?

A. Approximate 47,000.

Q. And they're all under this lease program?

A. Oh, no, sir. We have a little over 200 we manage for other people, we have I think 50 or so that we picked up [47] from another company that was doing a lease and these people took their phones back and we leased them from them. There was no money exchanged, we just took over the lease for them.

Q. Does ETS own any?

A. The phones that are not assigned.

Q. Okay, now Hayes, National Communications and Bee—am I missing any others?

A. No, that's the only three we have.

Q. When they sell a payphone to an individual or a customer, do they—where does the payphone come from?

A. They get the payphones—the marketing groups buy the payphones from PSA, which is a subsidiary of ETS.

Q. Where is PSA located?

A. In—the actual corporate office is listed where I'm at. We warehouse the equipment and everything at ETS.

Q. So approximately how many payphones are sitting in the PSA warehouse right now?

A. In the PSA warehouse, there's probably 2000 or so.

Q. Maybe 2000 in there, in inventory right now?

A. Yeah, ETS probably has got probably 5-6000 that's in different phases of being installed.

Q. Okay, let's go into I guess the sequence here. How does Bee market these payphones, to the best of your knowledge?

A. They have a marketing group of independent [48] marketers and they contact individuals and sell payphone equipment. If those people buy the equipment, then they have a choice of either putting it up themselves and operating it or they can contact us and if they contact us they have a couple more options, which allows them to—we'll put up a payphone for them and do everything and they take all the risk, they pay us a flat fee and they get the profit or loss off that phone; or they can do the lease, we take the risk and they get a flat monthly lease payment.

Q. But the actual payphone itself, Bee sells the payphone and, what do they do?

A. Bee sells the payphone and gives a bill of sale direct to the individual with serial number of the payphone equipment.

Q. And how do they get the serial number?

A. From PSA.

Q. They purchase exclusively from PSA—that was Bee, National and Hayes—is that correct?

A. The phones that ETS leases, I would think so; yes, sir.

Q. Going back to the original cost, is it still $3000 to PSA for the purchase of these payphones?

A. Well, it depends. Last year, our cost of an acquisition was a little over $4200 per phone. A cost to put up a new pay phone and get it profitable, because 30 to 40 [49] percent of the payphones that we do new installs

with never become profitable and we have to move them to make them profitable, we have basically the same cost per phone, by the time we new phone profitable too.

Q. I'm just talking about the original cost I guess.

A. If I'm—just original cost on the payphone?

Q. The ones sitting in the PSA warehouse.

A. With all parts, about $1000 to $1100, depending on—

Q. Oh, that's right.

A. And that's the phone housing itself with a board.

Q. Well, if someone from Bee purchases a payphone, does PSA assign the location?

A. No, sir, ETS assigns the location.

Q. I guess PSA just sells the actual payphone itself?

A. They sell the actual equipment.

Q. Sell the actual equipment, and ETS finds the location for the Bee investor.

A. Correct—well actually finds it for the phone owner.

Q. And then ETS has all these locations sitting out there.

A. We've got approximately 13-14,000 locations today we don't have phones at that are paid for.

Q. You've already paid for the location?

[50]

A. Yes, sir, they're under contract.

MR. SORRELS: Can we take a break when you get to a stopping point, Barry?

MR. LAKAS: Let's go off the record at 11:11 a.m.

(A short recess was taken.)

BY MR. LAKAS:

Q. Going back to that statement you made that there's, what was it, 3-4000 locations that haven't been—

MR. SORRELS: I think it was 13-14,000.

MR. LAKAS: Oh, yeah, you're right.

BY MR. LAKAS:

Q. Okay, 13,000-14,000 locations that have been located that have not been sold yet?

A. That we have location contracts to put payphones in.

Q. There are no payphones at these sites at the present time?

A. Not as yet; no, sir.

Q. How much does Bee, Hayes, National Communications, how much do they get for a payphone location when they sell it?

A. They're selling the equipment, the location, the package. The suggested retail today is $7000.

Q. And who came up with that figure, was it Bee or you helped?

[51]

A. I would say I did, we did.

Q. And what does—well PSA sells the payphone to Bee.

A. Right.

Q. What does PSA get?

A. $5250.

Q. $5250. And what does ETS get, just the leasing arrangement?

A. I need to change that $5250. $984 of that $5250 goes direct to ETS for the install from the distributor, and the remainder comes to PSA. And that started the first of last month.

MR. LOUGH: That was $900 and how much?

THE WITNESS: $984.

BY MR. LAKAS:

Q. That's usually the amount of the first year's lease payments?

A. Yes.

* * * * *

[53]

Q. Now the universe of payphone units, is this universe unlimited? I mean, how can you keep selling payphones? It seems like there's got to be some type of limit to the number of payphones that can be sold.

A. There's approximately 2.3 million payphones in the United States. In the country of Mexico, they're wanting an additional two to three million new pay phones installed over the next five years. That's the goal of the government. Internationally, it's a wide open market in South America and the different islands; in Europe, it's an already completed industry.

Was that what you were looking for?

[54]

Q. Well, it seems to me like different cities have different regulations, only so many it seems like you could only put so many payphones up.

A. Oh, I'm sorry, I apologize –

Q. You're kind of addressing it.

A. The way we get our phones is we either do an acquisition where we purchase a payphone route which is already existing sites or like we just got the Circle K account, so we will go in and replace the independent payphone provide that's there with our equipment, or we do new installs, which would be a new convenience store opened or restaurant, whatever it may be. And we do—last year, approximately 60 percent of our phones were through acquisitions, 35 percent was through replacement and about five percent was through new installs.

Q. I'm sorry, 60 percent was—

A. Through acquisitions.

Q. Through acquisitions.

A. Buying other—

Q. Of old sites?

A. No, buying existing payphone companies.

Q. Oh, I'm sorry, existing sites. Who do you usually buy them from?

A. Independent payphone owners.

Q. You mean just the individual person who bought it [55] for whatever reason?

A. No, the last company we bought was Triangle, 2200 payphones. They had a very strong operating

business and the gentleman was retiring, so we bought his business. We bought all his technicians and trucks and everything, took over his business.

Q. I guess that kind of addresses my question. That's kind of finite because there's only so many out there that are existing at the time.

A. Correct. The industry is really in a consolidatin because of all the changes happening in it. We have bought payphones from GTE, when they have chose to move out of a state, we bought the payphones from them. We have bought probably—and I don't know the exact number, but I'll make a guess of probably 80 individual routes from different people over the period of time.

Q. What about new payphone locations, what's the competition? Say someone opens a convenience store, I mean, do you automatically send someone there to try to get the location or does BellSouth send someone there? How does this—

A. Yes, all the above. Most of the time when we have a convenience store chain on contract, then any time they build a new store, we automatically get that account. We have all the Diamond Shamrocks nationwide, we have all the [56] Convenience Stores USA, the Swifty Serve, Murphy Oil. We have the Phillips 66, we manage their phones nationwide. We have the Texaco Star Marts in Texas and in Florida we have the Golden Pantries. We just got the Circle K, I said. We've got the Daytona Speedway, Darlington, we've got basically all of the NASCAR tracks under contract. We have Tampa Stadium, which we've had some time. We've got a ball park at Arlington, we've got airports at Huntsville and at Montgomery. We've got a number of

counties, like in Pensacola, we have all the phones on the beach that the county has there. We do in Atlantic City. So it's—

Q. Municipalities?

A. We do a lot in the municipality, but as far as a complete municipality, no. The closest one would probably be Brunswick, Georgia where we have all the payphones in the courthouse and the lobby of the jail and all their parks and everything. We have half of all the phones in the roadside parks in Texas. Lots of hotels—Cobb Galleria here. A number of large shopping centers across country too.

Q. If I see one of your phones at a street corner, is that usually through the municipality or is it usually with the sidewalk rights with the business that happens to be near?

A. See, here in Georgia, BellSouth has the sidewalk rights. Any phone we have here is on private property. It [57] could be sitting on a curb, but it'd be sitting on like a convenience store's private property. Now in New York City where we have quite a few phones, now we've got two franchises in New York City where we have curbside phones that are licensed by the City.

Q. Because I've seen some of yours on looks like street corners, but I guess you're saying it's on private property.

A. Right.

Q. Associated with a convenience store or restaurant or something.

A. If they were on the street corner, the City of Atlanta would have already jerked them off because they are tough about that.

Q. Now what's your arrangement with the location owner?

A. We have either five, seven or ten year contracts where we have the exclusive rights to put payphones up. And then they get a percentage of the net revenue and sometimes it's of the gross revenue.

Q. Do you have to send them some kind of accounting records?

A. They get an accounting each month with their check on their phones. And the larger accounts, such as Diamond Shamrock, you know, we've got 5000 phones with them, so they [58] get a breakdown of every phone.

Q. So you have what, a group of people that goes out and checks these payphones every month?

A. I've got 300 people that do nothing but service payphones full time.

Q. So they're collecting the coins out of them every month?

A. Collect a minimum of once a month, they're normally at every phone twice a month. Some phones, the really good phones, we'll be there every week.

Q. So 300 people doing 47,000 pay phones?

A. Right. Now I've got—as I say, I've got subcontractors that will take—probably about 1000 of those are done by subcontractors. The rest are done by our independents.

Q. I'm sorry, how many offices do you have in other states?

A. Twenty-eight offices. That includes this office too, here in Atlanta.

Q. Are they mainly servicing people that run around to these phones?

A. Right. We have a regional office in Brooklyn, New York and a regional office in Dallas; one up in Minnesota and one in California. And then we have what we call branch offices, the rest of them.

[59]

Q. So you've got 300 people doing approximately 47,000 payphones per month.

A. Correct.

Q. How about—well, actually how many—you might have a good idea of this—how many of the payphones are actually profitable, of the 47,000?

A. Forty-two. We've got somewhere around 6-8000 that are marginal phones. Advertising is one of the new things that's really starting to generate tremendous revenue for us, and some of those phones will take advertising booths, so we're not pulling in—but that's why we try to cull a minimum of 10 percent each year of our payphones, because just the economic conditions make good phones this year that will be bad phones next year, or marginal. Or somebody will build a store next door and put up phones.

Q. How have cell phones affected your business?

A. In the top 40 percent of the payphones, we've had a decrease in revenue; the bottom 60 percent, we have not. So it has affected and that's part of the change that's happened in our industry.

Q. How does this work, say I have a calling card and I go up to one of your payphones—calling cards, you can usually just walk up to a payphone and—you don't

even have to put 35 cents in. Does it deduct part of the calling card?

A. No, because you'll dial a 1-800 number there to [60] get—that's called dial-around, we get compensated, as of today, at 24 cents per call on those. And that's been in turmoil with the regulators for the last three years and hopefully, we're going to get another—a decision is coming down this next month that will clear that up. But it's eventually going to come back to the pay phone, in my personal opinion.

* * * * *

BY MR. LOUGH:

Q. You indicated that you cull approximately 10 percent of the phones each year.

A. Right.

Q. By that I guess you mean you take them out of service and relocate them or something like that?

A. Correct.

* * * * *

[61]

Q. Approximately what percentage or what number of the 47,000 phones that you have are subject to the kind of contract that requires that you maintain the phone, that you are not permitted to cull that phone?

A. I've got approximately 20,000 convenience stores, so I would say—which is about what, 40 percent of them, and those I would not want to cull, they're our best phones. That's why we are concentrating on convenience stores because when all this change happened, we chose to—how do you overcome the change, and we

vertically market into that store, we do their air and vac machines, we do ATMs, we do their prepaid calling cards and we do the long distance for that one location. And now of course we're doing advertising, which is—I'd like to talk a lot about that, but you haven't asked that question.

(Laughter.)

Q. You're talking about advertising on the phone?

A. We have the right to a patented payphone booth and what started this, when we got our two franchises in New York [62] City, at the same time they let five contracts to advertising agencies to sell the advertising on payphones. We are currently contracting with a company called Outdoor Concepts. On our Manhattan curbside phones, they're paying us a $7000 signing bonus and guaranteeing us a $450 per month minimum net-net-net commission on our phones because the City gets a commission since it's curbside and I don't have a location.

My outer boroughs got a $4000 signing bonus and a guarantee of $150 a month. Now I have a 15-year contract with the City on those phones and I have a five-year contract with the advertising company on the guarantee.

When I saw that, I says if that'll work like that, I've got 20,000 convenience stores out here that tobacco is screaming for some place to advertise and they can advertise up to 13 square feet on private property where cigarettes are sold over the counter—convenience stores.

So we started looking, and we patented two different types of phone booths in conjunction with the manufacturer. We have an illuminated 12 x 18 over the

phone and we have a two foot by three foot on the back and a two foot by three foot on each side that are illuminated 24 hours a day. That booth will generate an additional $725 per month gross revenue. Then we developed one that's on the wall and whether it be on the wall of a convenience store or a wall of a sports bar, that has an angled ad on it so it doesn't take [63] out the walk room when you walk by it or so on, it has one over it.

So we've done two contracts with R.J. Reynolds on advertising, one in the northeast where we've got our first booths going up, and one in Phoenix, Arizona.

It is manna from heaven, for a choice of a better word.

BY MR. LAKAS:

Q. How often do people want refunds? That is give you the 180 days notice?

A. Right.

Q. Or is it 90 days? I'm sorry.

A. 180 days. We have, in the first five years had a one percent per year average of liquidations. Last year, because I had two rescissions, we had a four percent liquidation.

* * * * *

[65]

Q. So in if 2002, 8000 phones—8000 purchasers wanted or elected not to renew or lease, that would be what, $6000 a phone or $7000 a phone?

A. I would say they were probably $6000 a phone at that time.

Q. So you're talking about what?

A. $48 million.

Q. $48 million. Say that happened, what—how is ETS going to pay that back?

A. Well, the payphone and location backs up every piece of equipment. If I did not have the revenue from my internal operations or from external resources, then I could sell the payphone locations to other payphone vendors. But our goal is certainly not to sell them, our goal is to own [66] them all ourselves.

Q. At the end of five years, how much time do you have to pay these people back?

A. Pay them—we notify them at 120 days prior and then at 90 days, whether we choose to purchase or not. And if they request us to purchase. Then we buy it back at the anniversary date.

Q. You buy it back at the anniversary date.

A. Yes, sir.

Q. So is there any pattern of these things going up, these locations? Because you said you believe that some—say only 1000 became due, you're saying that some other marketer or some other payphone company would buy all these locations.

A. Yes, sir. Let me explain why. Today, the value of a payphone is based on total sources of revenue from that payphone minus your line charge you pay the phone company, minus the commission you pay for that location, that's called gross net and we say times 30, that is the normal way payphones are sold. Now put advertising on these payphones.

Let's say that payphone booth that can generate $700 only generates $400 a month. The value of outdoor advertising is you take that $400 times 12 is $4800 times five to ten, so my payphone booth and phone now is worth somewhere from $25,000 to $30,000 each in the marketplace. That's current value [67] that everybody is paying for outdoor advertising.

So I'm saying I think my locations are going to be worth considerably more.

Q. You think.

A. Absolutely. I'll give you a personal opinion. I think payphones in five years will be worth—locations—will be worth between $10,000 and $12,000 with operating income on them. That's my personal opinion.

* * * * *

Q. Okay, let's go over this scenario. All 8000 payphones, the purchasers elect not to renew the leases, all 8000 are due. No company wants to purchase them. What are you going to do to make these people whole?

A. Well, I don't owe anybody anything. I don't know what it'll be two years from now, but today I don't owe anybody anything. So I have outside resources I could call on. All of my trucks, everything is paid for, my other businesses are there generating income, so I certainly can generate the revenue to buy them.

Q. If that happens though, you start selling your trucks—

A. No, I could borrow all of it.

Q. I thought you said you couldn't borrow from banks.

[68]

A. No, no, I said I couldn't borrow when I first started. You know, I'm in a whole different situation now. I was zero and we did $170 million last year, so we're a major payphone player. And then our other businesses, we've got a very, very large business here.

Q. But you do say 42,000 of these payphones are profitable, is that correct?

A. Yes, sir.

MR. LONG: Barry, could I ask some questions?

MR. LAKAS: Sure.

MR. LONG: There were a couple of points I'd like to get some further information on.

BY MR. LONG:

Q. Mr. Edwards, you said PSA was a subsidiary of ETS?

A. Yes, sir.

Q. Is that like a 100 percent owned subsidiary?

A. Correct.

Q. And is that the name of the company, PSA?

A. I believe it's PSA, Inc.

Q. Do you know where it's incorporated?

A. It's a—I don't know for sure. I'll have to check and find out for you, sir.

Q. Are there other subsidiaries of ETS?

A. Yes, sir, there's ETS Vending, which does the air and vac; there is POA, which is our limited partnership that [69] does Mexico.

Q. Are those wholly owned by ETS?

A. ETS owns 100 percent of Vending and it owns 60 percent of POA.

Q. Of course, I need to know who owns the other part of POA.

A. I know the two principals, but I don't know whether the stock is direct in their name or in a corporation they have—it's name. I can certainly get that information.

Q. Who are the principals?

A. Jack Limke and—oh, geez, I'll think of it in a minute.

Q. So those are all of the subsidiaries. Well, let's put it this way, those are all—this is all of the subsidiaries of ETS?

A. Correct, sir.

Q. Are there other affiliated companies that might not be considered subsidiary that are involved in these operations?

A. There's other companies that Twin Leaf owns, which I own both Twin Leaf and ETS.

Q. Have you mentioned those on the record already?

A. Yes, sir.

Q. You said last year there were two rescissions?

A. Yes, sir.

Q. Would you elaborate on what those amounted to?

A. One was in Kansas, which we got a cease and desist, and we had voluntarily stopped selling there. Instead of fighting and paying large legal fees, we chose

to do a rescission. Eleven percent of the individuals chose to take the rescission. And in Pennsylvania, we voluntarily stopped selling. There was no C and D or anything. And we did a rescission there, and 34 percent of the people took it.

* * * * *

[73]

Q. Before we go on, let me just ask a couple of things. You said that last year you had two rescissions, one resulted in Kansas and the other was in Pennsylvania?

A. Correct.

Q. And Kansas had followed as a result of a cease and desist order. What agency issued or entered that C and D, do you know?

A. I think the Department of Security in Kansas.

Q. And what is your understanding as to the basis for that cease and desist order?

A. They thought we were selling a security.

Q. In Pennsylvania, was there an inquiry that came from some regulatory body within the state?

A. The Department of Security.

Q. Okay. And it did not lead to a cease and desist order, is that right?

A. No, sir.

Q. Were any proceedings initiated?

A. No, sir, none. There was no proceedings in either one.

Q. All right. Have you had regulatory inquiries from any other state regulatory bodies?

A. Yes, sir. I've had them from Florida, from North Carolina, from Iowa, Oregon, Kansas and Pennsylvania —and Rhode Island.

* * * * *

[77]

THE WITNESS: If you're looking at the total number of phones operating as we have now, you probably have 34,000 that are totally profitable because some of them are in the process—new installs and so we don't really know what the profitability of them are yet. We know [78] approximately 34,000 are profitable.

BY MR. LAKAS:

Q. Going back to this Exhibit Number 7, do you recognize this document?

A. Yes, sir.

Q. Would you describe it, please?

A. It is the brochure and disclosure that is sent out to prospective lease holders when they request it from ETS.

Q. When they request it. So not everyone gets this?

A. Only—they either fax or send us a letter with a written request and it is sent out to them.

Q. How would they know it exists?

A. When the marketing people talk to them, if they have an interest in the leasing of the program, then they fill out a form and send it to ETS.

Q. Does that form identify this document?

A. It requested information on ETS, is what it does. It's a fax form, just a single page.

Q. Oh, so if they send that in to you, then you automatically mail them this?

A. Yes.

Q. Other times, they just take the person's check—they fill out an application, they take the person's check and they never see this? I guess I'm confused, why do some get it and some don't?

[79]

A. Well, everybody gets it that leases a phone.

Q. Oh, everyone does get this that leases a phone?

A. Everybody that has requested information on leasing—no, not everybody that leases—every one we don't—send out does not end up in a lease.

Q. Right.

A. But everybody that does a lease has had one.

* * * * *

Q. Who supplies it to the agents?

A. The agents do not handle it. It is sent out direct by ETS to the individual payphone owners who request it.

Q. Who request it.

[80]

A. Correct.

* * * * *

A. My understanding is that the marketing agent or salesman contacts a prospective phone owner, talks to

them about buying payphone equipment, they do not represent ETS in any way, shape or fashion. If that individual is interested in either leasing a payphone or having service on a payphone, then the individuals themselves request that we send them a package which we do. And then if they choose to lease the phone or take option 2, then we deal direct with the individual once they own the equipment.

* * * * *

[89]

BY MR. LAKAS:

Q. That's why—going back to my statement about how finite is the universe of selling payphones, because this financial statement looks to me like you have to keep selling payphones and payphones and more payphones to be profitable and to pay your expenses. Eventually this is going to have to dry up.

A. I would say yes to that.

* * * * *

MR. SORRELS: This financial statement doesn't [90] reflect anything in the way of advertising revenue, does it?

THE WITNESS: No, sir.

BY MR. LAKAS:

Q. Well, how much advertising revenue did you have last year?

A. I had zero last year.

Q. And what do you expect the advertising revenue to be next year?

A. This year?

MR. SORRELS: 2000.

THE WITNESS: 2000?

Q. 2000. Okay, this year. We're already in it, but—

A. We should hit pretty close to $15 million to $20 million.

Q. How much have you had the first three months?

A. We got our first check in last month. $8300.

Q. $8300? Is this $15 million based on the $8300?

A. That was the first—that was 103 of the booths we had up and of course that grows every month as we're putting our enclosures up.

* * * * *

[93]

Q. So is there a time lag between when people purchase a payphone and when they're assigned a payphone?

A. Yes, sir, it can be as short as two weeks and go as much as two to three months, depending on inventory and where they're going.

Q. Why would it go to two to three months? I thought you said you had 11,000 to 13,000 locations.

A. We do. Well, for instance, like we got the Swifty Serve account, which we took over January 1. These are [94] convenience store phones. Well, the people that are currently in there are just now taking their phones out, so although we've had the contract this long, it'll be another 45 days before we get the phones in those contracts and that happens occasionally, more

than we like, when we're replacing another vendor's equipment.

Q. Are purchasers of these payphones being told that there might be a three month delay before they—

A. Yes, sir. And then they get an addendum to their lease that states where their location is, so they can go out and feel and touch and see their payphone.

Q. But they get assigned a serial number right away, do they not?

A. Yes, sir.

BY MR. LOUGH:

Q. At what point in time do they receive information regarding the location of the payphone?

A. It will be anywhere from the time they receive their lease up to two to three months later, depending on the install. Then they get an addendum that gives the location of every one of their phones.

Q. Do they receive that directly from ETS?

A. Correct.

Q. That doesn't go back through Bee Communications or whoever sold them the phone?

[95]

A. No, actually Bee has sold them the phone and location. We assign the location, their location, which is part of the original purchase.

BY MR. LAKAS:

Q. But you said they are informed that they may not have a payphone for a few months.

A. Well, they've got a payphone—

Q. They might not have a location for a few months.

A. Correct.

Q. Okay, go to Note C, commitments and contingencies, which is on the next to last page. I'll read the first paragraph: "As discussed in Note A, the company leases payphone units. Lease arrangements provide that the company may purchase the payphone unit upon 30 days notice and the lessor as a put option to sell the payphone unit to the company upon 180 days notice."

The next line says, "If a significant number of lessors were to exercise their put option, the company does not have the available resources to satisfy its obligations."

Is that a true statement?

MR. SORRELS: As of December 31, '98?

A. Not in the bank. But we have other sources of revenue.

BY MR. LAKAS:

Q. What might those be?

[95]

A. You know, lines of credit, external financing.

Q. That statement there, are purchasers of payphones being informed the company does not have the available resources to satisfy its obligations if everyone were to exercise their options to sell the payphones back?

A. I'm sorry, I didn't understand your question.

Q. Are purchasers of payphones being told this—that the company does not have the available resources

to satisfy its obligations if a significant number of lessors were to exercise their put options?

A. I would not think so, no.

* * * * *

[99]

Q. They get them [the payphone assignments] automatically.

A. Yes.

Q. From that inventory of 11,000 to 13,000 locations that you have.

A. Right.

Q. If you go to the last page, there's a lot of lease numbers with serial numbers but with nothing on them.

A. That means there has been no location assigned to these, as of this date.

Q. So these people have purchased their payphones—

A. Correct.

Q. —So they're part of the 3000 or so at the end of the year that haven't been assigned payphones—or at any point in time.

A. Correct.

* * * * *

[101]

BY MR. LOUGH:

Q. Approximately how many phones per month are sold?

A. Last year, we averaged about 1250 a month.

Q. About 1250 a month?

A. I believe that's correct.

[102]

Q. But there is a lag time between the sale and the placement of the phone.

[103]

A. Correct.

Q. And I think you previously testified that can be a few weeks, it can be a few months. What's the longest lag time?

A. I think the longest we've ever had would be between three and four months.

Q. Okay. Do you know what the average would be?

A. I would say the average would be within six to eight weeks.

Q. Have you done any kind of a study of that, to actually determine what that is?

A. I did approximately six months ago.

Q. And that resulted in your determining that it was six to eight weeks?

A. Correct.

* * * * *

Q. Is that of concern to the company, that there is that period of time between the sale and the actual placement of the phone?

A. From my viewpoint, no.

Q. Why is that not of concern?

A. Because we are—if the delay is there, it's because of a legitimate reason and we are constantly working [104] to pull it back. It's just a matter of doing business, because the sales will come in, maybe 1000 this month and then 2000 next month. If I get 2000 sales a month, now that's going to put a pressure on us to get things caught back up, which we do.

Q. And you've said that you essentially have a certain number of locations that—I think you said between 12,000 and 14,000—

A. Correct.

Q. —that are under contract. Now a number of those are not available for installation, I take it, as present?

A. A few of them, yes. I would say probably 2000 are in the process of removing—well, maybe closer to 3000—in the process of removing the phones from existing vendors.

* * * * *

BY MR. LONG:

Q. I'd like to ask a couple of questions, Mr. Edwards. Concerning your compensation in 1999, it's not clear to me exactly what that was that grew out of the ETS operations either directly or indirectly. Would you state for the record what that was?

A. Well, PSA pays to Twin Leaf a management fee, a figure per phone.

Q. How much is that?

A. It's $250 per phone. And we cover all of our—[105] my management team, covers all their expenses and everything out of that.

Q. So what was your personal compensation in 1999 that came directly or indirectly from the ETS operations?

A. Okay, because PSA being ETS—$380,000.

Q. Was that your top year?

A. Yes, sir.

Q. With respect to the—if you view the ETS operations that have been described on the record as a method of raising capital to acquire phones, can you quantify the cost of that capital in a percentage basis?

A. It varies on each of the different leases because as we started, it was a higher percentage, but I would say on an average right now, it's about 14 percent—overall average about 16 percent.

Q. And that's paid to whom?

A. To the lease holders.

* * * * *

[107]

Q. If you had a source of capital say from a financial institution, what would the rate have to be in order to be a better rate than what you're paying now?

A. Of course 15 percent would be better. But see, that's one of the situations in our business, because after I talked to Mr. Grant and I gave the put to the owner, that he can come back and get the phone any time, he's got absolute control of the phone. Well, he sort of controls what I can and cannot do with the phone. If he chooses for me to buy that phone, then I can take those phones to Wall Street, if I chose, and raise the money because I've got the equipment to sell. Today, I don't own any phones, the owners own the

phones. So the cost of my dollars—the equipment came in, [108] I'm leasing that phone for the use of that equipment. So I've really not borrowed his dollars yet, I've got his equipment.

* * * * *

[PLAINTIFF'S EXHIBIT 21]

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

File No. A-02501

IN THE MATTER OF ETS PAYPHONES, INC.

INVESTIGATIVE INTERVIEW

TRANSCRIPT

APPEARANCES:

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* * * * *

Whereupon,

MARIO ROBERT COMMITO

appeared as a witness herein, and having been first duly sworn, was examined and testified as follows:

EXAMINATION

BY MR. LAKAS:

* * * * *

[14]

Q. Let's get to the questions now. Can you go over again how you got hired by ETS?

A. ETS actually ran an ad in the newspaper looking for a CFO. I was—I sent in a resume and they asked me to come in.

* * * * *

[21]

Q. Who was out there selling these payphones, to your knowledge?

A. There were independent sales groups.

Q. Okay, that's the marketing groups?

A. Marketing groups.

Q. ETS didn't sell any payphones themselves?

A. ETS sold no payphones.

Q. Now when you had your interview with Mr. Edwards or maybe even Mr. Ginsburg, did they go over the company structure?

A. Charles did go over the company structure.

Q. Do you remember what he said the company structure was?

A. The company structure was that there were actually two companies, one of which was ETS, which was an operator of payphones.

Q. Okay.

A. The other company was PSA, which was a company that did the acquisition of the routes and sold phones and Charles was very careful about this distinction—sold phones to the independent marketing companies.

Q. Seller of payphones—and that was PSA subsidiary of ETS?

A. A sister company I believe, not a subsidiary.

[22]

Q. So then who owns stock of PSA?

A. I believe it was owned by Twin Leaf, to my knowledge, which was Charles' personal company.

Q. Twin Leaf owned PSA?

A. I believe. I'm not sure, I did not do anything on Twin Leaf's books.

Q. Were you hired them to be the CFO for ETS and PSA?

A. And PSA.

Q. For some reason, I always thought PSA was a subsidiary, because the audit—not the audit, they don't have audited financial statements—but the consolidated financial statements I've seen—

A. They combine the two.

Q. They do combine the two. It says ETS Payphones, Inc, and this is Note A to the December 31, 1998 financial statements which I'm going to show you later, it says "ETS Payphones, Inc. and subsidiaries are engaged. . . ."

A. There's a bunch of other subsidiaries.

Q. But PSA was not a subsidiary.

A. I think it was a sister company, I'm not sure. I never saw the '98 financials, they didn't finish them—

* * * * *

[23]

Q. But ETS—you're not sure if PSA is included in the—

A. No, I'm not.

Q. —in the financial statements. So you believe Twin Leaf owned PSA. Now what's Twin Leaf?

A. It's a holding company or a company owned by Charles Edwards personally.

Q. A holding company, and what do they hold, just PSA?

A. PSA. They may own ETS, they—I believe Legends was under Twin Leaf.

Q. So Twin Leaf also owned—well, when you say Charles Edwards controlled ETS, it was actually Twin Leaf owning it?

A. Well, Charles was Twin Leaf.

Q. Well, give me all you know about Twin Leaf.

A. Very little. It was a company that was Charles Edwards' company, it wasn't even domiciled with us. Their whole function, I don't know what it was, I never did the books for them, they were done by Dan Weldon.

* * * * *

[25]

Q. So you have Twin Leaf as a holding company and under that, you have ETS, PSA and Legends?

A. Uh-huh.

Q. Any others?

A. There were some—there was an LLC but I'm not sure what the ownership was there, that we put together with a company in Mexico to do payphones in Mexico City. And there are long acronyms involved there in Spanish. And there was a company set up here in the states to be the LLC that would own the Mexican company. And I believe Twin Leaf was the partner of that LLC.

Q. How about a company called I believe it was MSC?

A. MSC was a subsidiary of ETS.

* * * * *

[26]

Q. How about Pleasant Hill, have you ever heard of that?

A. Pleasant Hill, vaguely remember it.

Q. I believe it was just a company owned by Charles Edwards that owned the building that—

A. That's what it is, they were just breaking ground on the building when I left.

Q. How much did you deal with Don or Dan Weldon?

A. Only in the sense of we talked about setting up systems for Legends, recommendations back and forth. We talked about—prior to him being an employee, he explained to me some of the structures between PSA

and ETS because he was involved with Charles at that level. And then information back and forth for cash advances that—when we transferred money out of PSA, I would get notification that money had been transferred and then I would confirm with him who received it.

Q. Where was the money going?

A. Twin Leaf primarily, PSA would pay that overhead fee. Occasionally we did—at the very beginning we did some small advances to Legends.

Q. How much—well during the time you were controller or CFO, do you know how much approximately was transferred from PSA to Twin Leaf?

A. It was—I couldn't give you an exact amount but [27] it was probably in the range of $100,000 to $150,000 a month.

Q. So you were there almost a year, is that correct?

A. Right, just short of a year.

Q. So maybe $1.2 million?

A. Yes.

Q. Any other type of advances to Twin Leaf from PSA or ETS?

A. Not while I was there. There was a lot of things done prior to my getting there and I don't have access to the records as to what the opening balances were.

Q. How about Legends?

A. Legends, I think the total we gave them was very small, it was over about six months to cover payrolls and things as they were rebuilding the switch and

setting it up. And it was probably a total of about $200,000 to $300,000 over the entire year I was there.

* * * * *

[29]

Q. Did you have any disputes with Charles Edward when you were working for ETS?

A. Not disputes. I mean we had discussions over a number of things. I take the position as a CFO that I have to look at things with a very clear, hard eye. Charles once sat me down at night and said I sense a certain amount of negativity. I said no, Charles, it's not negativity, when there are problems, you face them.

Q. What were some of the problems that you were having?

A. We were losing money as an operating company.

[30]

Q. Okay, did you do the financial statements?

A. Yes.

Q. For the company?

A. Yes.

Q. This is kind of tricky. Did you consider the sale of the payphones as revenue?

A. Yes, we treated them as revenue.

Q. Is that the way Charles Edwards wanted them recorded—

A. Yes.

Q. —on internal financial statements?

A. Yes, it is.

Q. Did you see any problem with that?

A. When I joined the company, they had had a prior accounting firm named Gross, Collins & Cress, it's a local firm and a good firm. And they had refused to issue a statement recognizing the sale of the phones by PSA as a revenue item. The audit for the prior year, which was '97, had never been closed. And the—

Q. Was that Grant Thornton?

A. No, that was Gross, Collins.

Q. Oh, that's right, they weren't in yet.

A. And when I came in, what I wanted Charles to do was to get an opinion, clean opinion, on the company and he wanted the recognition of the revenue. I met with Gross, and [31] of course I got the job of getting them to cut the outstanding fee, which had been run up to like $140,000 for a small audit. We reached negotiation and they were dismissed as auditors.

And he said who should we bring in and that's when I recommended Grant. When Andre came in, we spent a considerable amount of time on the issue and I'm not a GAAP expert, that's why I bring in people that area. I'm a business accountant.

Q. Right.

A. Andre spent untold hours both with his staff, with me, also with the managing partner of the office here and they even brought in their GAAP experts from I believe it was D.C. And they could not come to a way—now they could recognize pieces of it as prepaids or fixed assets, they could do a number of things, but they could not come to a way to recognize as pure revenue the sale of the phone.

Q. Yeah, from a GAAP viewpoint, I just don't see how these things could be considered revenue. But for internal purposes, I guess you could account for them any way you want.

A. Sure.

Q. There's usually nothing wrong with that.

But do you know how Charles Edwards reacted when the CPA firms told him that he couldn't recognize—

[32]

A. He tried to convince them that these were truly sales.

Q. Well, no audit report was ever issued, was it, because of the fact that these payphone sales could not be recognized as revenue?

A. That's correct. Gross, Collins got to the point in the draft, but recognized debt rather than revenue and they were let go because of that, it was not an acceptable report. And Grant was still working on it when I left, but they could not come up with a GAAP presentation that they could make an opinion on.

Q. So it looks like Charles Edwards had a dilemma. Why did he want audited financial statements?

A. Well, Charles' long-term thinking is to be a public company and he recognized the fact that you'd have to be GAAP, you'd have to be audited, you'd have to have a reasonable firm give that attestation. That's why I brought in Grant because I thought that they're big enough to do a public offering and yet they're small enough and boutique enough that they really do give you a lot of good service.

Q. Right.

A. So that was his long-term plan, was public.

Q. Well, when you see the financial statements, and I'm going to show them to you later, from a GAAP viewpoint, it's pretty obvious that this company existed from the sale[33] of new payphones. I mean, you can always argue that any company has to exist from the sale of their products, but this company was making their lease payments from the sale of new payphones, they—and actually the sale of these new payphones were actually, to me, more capital lease obligations or debt instruments. Technically the company, to me, had like a $350 million liability because they had a promise to buy these payphones back.

Was Mr. Edwards aware of that?

MR. LEONARD: When you say company, are you talking about ETS or PSA or the combination?

MR. LAKAS: Well, the whole thing, I'd say the combination.

BY MR. LAKAS:

Q. To your knowledge, was Mr. Edwards aware of that situation that this company was really existing and was dependent on making its lease payments from the sale of new payphones?

A. To my knowledge, Charles felt that this was a very good deal for the payphone lessor and owner.

Q. Oh, yeah, it was.

A. That he felt that he had done people a great favor and he actually gave a number of speeches where he felt that he had changed people's lives for the better by the stream of income that he had provided for them.

[34]

He also recognized that at some point, you know, a payphone is going to be tendered back. But I think that was where he felt that the public company would be important. That people would be willing to tender back in exchange for stock in a public company.

Q. So his long-term plan was to convert that so-called debt that he would owe these people for the payphones in the future to some type of equity instrument?

A. Well, either that or by raising funds in the public arena, being able to actually buy the phones back, because it was his statement on numerous occasions that he wanted to own those phones and not be in a position of leasing them, that it would be much more effective to have a large company owning the phones.

Q. Right, because if these payphones were so profitable, why didn't he just own them himself?

A. Because to build up quickly, you need some funding vehicle.

Q. So these were funding vehicles.

A. Not funding vehicles in that sense. The statement I was about to make is, as a startup company, you can't fund out of a bank, nobody is going to give you a loan. As a matter of fact, I approached a couple of bankers I know and they said fine, put up a CD and we'll lend you the amount of the CD. Well, terrific.

[35]

He felt that he was in the business of signing leases just the way you would lease trucks or tractors or construction equipment or anything else, on a

leaseback from an owner of a payphone. That was his contention throughout the entire time I was there.

* * * * *

Q. Right. Well, let me show you these financial [36] statements now. I'm handing the witness what's been previously marked as Exhibit Number 9. These are compiled financial statements of ETS Payphones, Inc. as of December 31, 1998. I'll let you look at those for a minute or two.

(The witness reviews the document.)

Q. Have you seen these financial statements before?

A. This look like—I'm not sure, but it looks like a draft that was prepared by Grant Thornton.

Q. Did you participate in the preparation of these statements?

A. I believe I—I believe this is what I gave to Grant as the way we were keeping the internal statements.

Q. If you go to the consolidated statement of operations, on the third page, it's kind of blacked out, but do you see operating revenue almost $100 million. I would assume that the sale of payphones were included in that operating revenue.

A. Yes.

Q. Well, if you go to the balance sheet, though—and this is what I'm really interested in here. Under current assets, the fourth line, it says, accounts receivable affiliates. Close to $4.5 million was advanced to affiliates. Do you know who those affiliates were?

A. I would have to go back to the original books and records and see who they were. Most of that was on the books [37] before I was there.

Q. It was?

A. Oh, yeah. When I got there—

Q. Did you ever do any type of chart or workpaper reconciling that account, or just determining, you know, who owed that money?

A. I think there was a worksheet in the files there that had been done by Kevin on a monthly basis.

Q. I remember seeing one Grant Thornton worksheet. It said a lot of it was to MSC, but then it was—it looks like it was adjusted out back to Twin Leaf.

A. MSC was incurring loses and they were sending money up there to cover payroll and to cover—now that you mention it, it was—about 2 to 300,000 a month was going up to MSC for loses.

Q. Well, to your knowledge, was Charles Edwards just taking money out of this company and sending it to his affiliates?

A. I think—I don't remember that it was going outside the company very much. It may have been prior to my getting there. But there was very little cash flow within ETS. PSA had the cash flow. ETS was incurring loses on an operating basis every month, as was MSC, which was folded into ETS as part of their overall loss.

Q. And MSC was just doing the same thing that ETS [38] was, just managing payphones?

A. Just managing the 2,700 phones.

Q. Well MSC, though, was a subsidiary of ETS, is that correct?

A. Yes.

Q. So any money that was advanced to them should have been canceled out—wouldn't show up as that—

A I would have to go back to the actual financials—you know, our general ledger.

Q. Okay. What I'm showing you has been previously marked as Exhibit Number 15. These are the consolidated financial statements and accountant's compilation report for ETS Payphones, Inc. as of March 31, 1999, which is three months later. This was compiled by Grant Thornton. These financial things have been prepared on what I consider a modified GAAP basis. The revenues from the sale of payphones are not included as actual revenues. They do set up capital lease obligations.

A. And record the equipment.

Q. Right. They have reported the equipment as assets. But if you go to other assets under the balance sheet, you'll see the account, accounts receivable affiliates. It's now up to over $8 million, and at December 31st, 1998 it was only 4.5 million. So it's gone up another $3.5 million in a period of three months.

[39]

A. By this time there was also the Mexican operation, which, I believe, was related to ETS because it was payphones.

Q. What was the name of this Mexican operation again?

A. I've really forgotten it. It was a—it was in Spanish.

Q. So—

A. There was money flowing to the other operations, but they were payphone operations.

Q. Who was responsible for writing checks?

A. Checks that were paid for bills and for telephone bills and operating expenses were written in the accounting department and they were done on a signature slogan and it was Charles' signature and mine while I was there. Any movement of funds was done by a wire transfer and it was done by his personal secretary, who was also the corporate secretary. We would get a slip of paper, a recap, at the end of the month that would list all of the wire transfers that she had made, both any wires that came into the company and wires that went out from the company. There would be a journal entry made to pick those up.

Q. Okay. Do you remember—because you were obviously controller or CFO at this time, do you remember where this money went to for it to increase that much in a three-month period, to go from 4.5 million to $8 million?

[40]

A. I would think that—since this includes PSA, I would think—I'm not sure. It would have—I would think this includes PSA in this statement—

Q. I think it does, yes.

A. —so I—

Q. It would have to because the payphone sales—

A. Right, are in here.

Q. —are included.

A. Legends by that time would have gotten some significant dollars because they had to buy the switch and that was a third of a million dollars to buy the switch, and then they had to spend a lot of money for equipment to bring it up to spec that they had to purchase from the manufacturer of the switch. So there were probably, during this period, half a million to three-quarters of a million dollars that went into Legends. The acquisition or the joint venture in Mexico, there was about 3 or $400,000 worth of open bills to a company called Elkotel that makes phones that it shipped to the Mexican operation. They needed them to put them up and they were stalled at the border because the Mexican operation had never paid for those phones. So that had to be cleaned up.

You would have had payments or loans made from PSA to Twin Leaf. I think that the —

Q. Do you mean $225 per payphone?

[41]

A. The 125 and any other additional funds Twin Leaf needed. I know that they had put up by this time—or shortly thereafter we were up to—Pleasant Hill had used 6 or $700,000 worth of advances, which probably came out of—

Q. Do you know what they were for?

A. For the construction of the building, and that came out of PSA also. So there's almost $2 million right there. So, you know, the funds that were being spent were—they were going out of PSA, not out of ETS.

Q. But you still were the controller for PSA?

A. Yes.

Q. In your opinion, were these payments being made for legitimate business purposes?

A. It would be strictly an opinion.

Q. That's what I'm looking for. That's all you have.

A. Some—well some. Some of the things that I—that Charles had done over the years—which I'm not sure where the money came from, but ultimately, I assume it came somewhere out of the companies. He made an investment to remodel a home down in the islands, which I didn't think was—you know, at the stage of the company—I'm pretty much a conservative accountant and at that stage of the company, I thought that wasn't the brightest use of money. That was done before I was there. So some of these—

Q. Who told you that was done?

[42]

A. He did.

Q. Was it done through Twin Leaf? Did he—

A. I believe so, yes.

Q. This was an investment in his—in a home where?

A. St. Simons.

Q. Did he tell you how much he—

A. It was a lot. I mean, it was hundreds of thousands. The building we were building was—I thought was a decent investment in terms of a company headquarters.

Q. Where was this going to be?

A. It was at Pleasant Hill and Peachtree Industrial.

Q. That's why it's called Pleasant Hill. That makes sense.

A. Peachtree Industrial and Pleasant Hill, which is a good construction area for offices. I thought that was a reasonable business use.

Q. What was he going to do, consolidate everything there?

A. He was going to consolidate the Twin Leaf operations there and the corporate operations there and leave the—because the daily operations require a lot of truck storage, materials storage. It requires a loading dock that is secure so that you can bring a Brinks truck in and load it up every day. They had to have a secure safe area where they did the coin counting. It doesn't lend itself to high- [43] quality office space.

Q. Where's that now, in Lithia Springs?

A. That's in Lithia Springs.

Q. Is that where your offices were located?

A. That's correct.

Q. I'm trying to remember where Lithia Springs is. Is it on the west side of town?

A. It's on the west side. It's the exit after Six Flags.

Q. Okay. Getting back to Twin Leaf again, what—we've been over this before, but refresh my memory. Does Twin Leaf have any legitimate business purpose?

A. I have no idea what Twin Leaf did. I do know that we advanced money, as I say, as an override out of PSA, 125 a phone.

Q. So you just followed the instructions—

A. Well, we didn't even—it wasn't a matter of me advancing. I mean, I would get a slip of paper that says there were X hundreds or thousands of phone sales made this month, times $125, and we wire transferred this money, please record it.

Q. Twin Leaf had a separate bank account from PSA and ETS?

A. Yes, each company had their own accounts.

Q. Well this $8 million to affiliates, do you know [44] how much was advanced to Twin Leaf?

A. No, I don't.

Q. I thought the amount that you had advanced to Twin Leaf was $250 a payphone?

A. It may have changed after I was there.

Q. It was just $125 the whole time you were there?

A. It was $125 all the time I was there.

Q. Did you ever question Charles Edwards about some of these payments to Twin Leaf?

A. No. He's a 100 percent owner.

Q. It's his company, I realize that. I understand that.

* * * * *

BY MR. LAKAS:

Q. Mr. Commito, while I've got you, let's go over the internal structure of ETS and PSA. Who was the chief operating officer of PSA?

A. Charles—Charles Edwards.

Q. Was anyone else involved in the operations of PSA?

[45]

A. There was a separate staff that did all of the contact with the lessors. The placing of the specific phone numbers and all of that was handled by a clerical staff.

Q. Well that would have been in ETS though, wouldn't it?

A. No, they were in PSA. They were PSA employees.

Q. And they handled the lease—the lessors?

A. They handled the lessors, they handled the—

Q. Paying the lessors? That would come out of ETS, wouldn't it?

A. Paying lessors came out of ETS, but all contact with the lessors was done through a separate group of people.

Q. Okay. And who was in charge of that department?

A. I forget the name. There was—there were about three departments and they were basically under Joan —I think her name was Wagoner, but I'm not—no, no, Wagoner was the attorney. I don't know Joan's last name. She was Charles' secretary and the corporate secretary, so it'll be somewhere in the corporate minutes.

Q. Again, ETS, what was the structure of ETS? Who was the—

A. When I joined ETS, Charles was the president and CEO; Larry Ginsburg was the chief operating officer and I was the CFO.

Q. And what other departments did they have in ETS?

[46]

A. They were manager-level people in charge of the actual field operations and when I joined the company, Jason Edwards, who was Charles' son, was in charge of field operations. He was in charge of maintaining the phones and collecting the money for the Atlanta area.

Q. Just for the Atlanta area?

A. Yes.

Q. Well they were in 38 states. Who collected. . .

A. Well they only recently were in 38 states. They had a structure of regions. Florida being a region. The Southeast, out of Atlanta, there were a few phones. Most of the phones were in the Atlanta—the immediate area, with a few phones in North and South Carolina, probably 100 in Tennessee. They just had local offices. In some cases they had independent contractors collecting the money and maintaining the phones.

Q. Who would those independent contractors be, individuals or corporations?

A. Individuals or companies that were in the business of maintaining payphones.

Q. So they didn't have offices in all of these states that they were working in?

A. No. When I was involved there, we probably branched into five or six states. We were probably up to about 12 states at that point.

[47]

Q. That's all?

A. Yeah. The growth has been phenomenal. One of the last things I did in March and April of '99 was to consummate the acquisition of a company in Texas, which got them into about seven or eight new states. It got them into Oklahoma; it got them into the Chicago area; it got them into the upper Midwest.

* * * * *

[51]

Q. How did this company look on a cash flow basis while you were there?

A. ETS Payphone was not cash flowing positive. It was a negative cash flow—significant dollars, and PSA was a very high positive cash flow.

Q. You were always doing separate analysis for each company?

A. Yes.

Q. You never combined the two for—

A. We combined them on a statement basis, because Charles, you know, wanted to present a picture of the total operation.

Q. Okay. Now the ETS Payphones, you say, from a cash-flow viewpoint was not making money, correct?

A. That's correct.

Q. What did—what were the cash-flow sources for ETS Payphones? When you say it was losing money, where was the money coming from and where was it going?

A. The money came from three basic sources. One is the actual coins collected from the telephones themselves. The second was what's called dial around, which

is when someone dials an 800 number to access a long distance carrier, the law was passed that the payphone is entitled to receive some compensation. So the individual long-distance carriers were supposed to send money every month to the [52] payphone owners or operators. Then the third source of funds was advances out of PSA.

Q. Advances from PSA?

A. From PSA.

Q. So would you say payphones themselves are a profitable business based on what you learned at ETS? Actually were ETS' payphones profitable?

A. No.

Q. ETS' payphones did not make money?

A. No, they did not.

Q. And by operations, we mean the money come into the actual payphones and the maintenance of them and paying employees for servicing and administration, payphones at ETS were not profitable?

A. Correct.

Q. Do you know if they were losing money before you got there?

A. Yes, they were.

Q. And when you left they were still losing money?

A. Yes.

Q. Was Charles Edwards aware of that?

A. Yes.

Q. Was there ever any meetings with him about this, where this was discussed that we're losing money on these payphone operations, what should we do?

[53]

A. Numerous.

Q. Did he say let's just go out and sell more payphones to remedy this?

A. He would demand more efficiencies in the operations. He would look at is dial around being sent on time, which, of course, it wasn't because there were continual lawsuits back and forth between the payphone owners association and the long distance carriers saying we don't agree with the court. Whatever the courts came up with as a split, the other side would counter sue that felt that they had lost. So we were owed millions of dollars in dial around. But even then—

Q. But every payphone operator had that problem.

A. That's right. The expenses were too high, and Charles' attitude was, if we can get to a critical mass with the number of phones, then the expenses would even out.

Q. In your dealings with Charles Edwards and this whole company ETS/PSA, were they more in the business of operating payphones or just selling these payphones?

A. ETS was heavily involved in operating payphones.

Q. They were?

A. We had hundreds of employees on the street collecting phones, cleaning phones. Charles had extremely high standards, that he wanted the phones to be

maintained, those added to the cost inefficiencies. For example, he [54] wanted every payphone actually physically visited by a technician twice a month. Collections twice a month. There were phones that didn't call for collections twice a month. It's a very difficult business at best.

Q. Well did he ever stress selling more and more payphones as opposed to operations?

A. The sale of payphones had nothing to do with ETS. That was strictly a PSA function and the people in ETS really weren't involved in that at all.

Q. Well you were also the controller of PSA, though, weren't you?

A. Right, but I had no contact with the sales side of that business.

Q. Because that was done through these independent marketers?

A. All through independent marketers.

* * * * *

ETS Payphones, Inc. - The Pay Phone Experts

ETS Payphones, Inc. has owned and operated public pay telephones since 1992. Growing from a local operation based in Atlanta, Georgia, ETS has expanded to a national firm with equipment and facilities located throughout the United States. ETS installs only the most technologically advanced Smart Phone equipment, which is monitored 24 hours a day from a central facility. With technicians and maintenance facilities located throughout the country, pay phones can be managed efficiently, with a timely response to every signal.

Welcome to ETS

"Smart Phone" Technology

Profitable Opportunities

ETS owns and operates pay phones throughout the country and offers a wide range of services that include the management and service of independently owned pay telephone routes. A recent study indicates that independent operators of public pay telephones, such as ETS, can provide a higher level of service while incurring lower costs than the larger, less efficient operators.

The broad base of operations built by ETS Payphones, Inc. crosses many states and governmental boundaries and provides a high quality, efficient management system for pay phone owners from coast to coast. This includes the management of pay phone equipment located in national fast food chains, restaurants, hotels, convenience stores, airports, sports arenas and other facilities that include pay phones on site.

For the pay phone owner, the need to contract individual management agreements for pay phone equipment on a state-by-state or region-by-region basis is eliminated. Both the site owner and pay phone owner can benefit from the experience, operating efficiencies and management expertise provided by ETS Payphones, Inc. Profits are maximized and all reports on pay phone activity are provided from one central location, in a timely manner.

PLAINTIFF'S EXHIBIT 22

BEST AVAILABLE COPY

ETS Offers the following services:	
• Replacement of antiquated equipment in existing locations • Locating sites suitable for public pay phones • Securing a local operator service provider • Securing a long-distance service provider • Coin box collections	• Installation of new equipment • Internal pay phone equipment maintenance • External pay phone equipment maintenance, including cleaning • 24-hour equipment monitoring of "Smart Phones"

[redacted]

ETS PAYPHONES

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E-mail: info@etspayphones.com

[redacted]

ETS

Welcome to ETS

"Smart Phone" Technology

Profitable Opportunities

The Smart Phone Difference

Independent pay phone owners and operators are changing the landscape of the pay phone industry. Much of the pay phone equipment currently installed is obsolete. Independent pay phone operators, such as ETS Payphones, Inc., who install the most technologically advanced equipment, have a competitive edge over older, larger operators.

The "Smart Phone" is the state-of-the-art telephone equipment of today's pay phone revolution. These phones are designed to "talk" with PC-based systems to manage every function of the pay phone from a remote, centralized location. The Smart Phone equipment installed by ETS is equipped with a micro-processor that incorporates self-diagnostic and reporting functions, with monitoring capabilities from a central location via computer modem. Older equipment does not have these "instantaneous" communication capabilities and must be serviced and managed individually, and usually, in person. Smart Phone technology results in superior "hands-off" operation, unparalleled efficiency and optimum profitability.

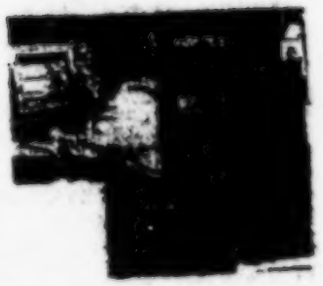
Smart Phones not only require less hands-on maintenance, but also can report equipment malfunctions and the number and type of calls being made from each phone. With this type of reporting, it's possible for a pay phone owner to know at all times how each pay phone is performing.

Pay phones must be operational to produce revenue. The longer a pay phone is out of service, the less opportunity exists for income. The monitoring capabilities built into Smart Phones signal the ETS control center when phones are not operating properly. When signaled with a problem, ETS quickly dispatches a maintenance technician. Phones can be returned to proper operating order rapidly, with as little interruption in revenue generation as possible.

All pay phones installed by ETS are equipped with the means to manage the following electronically:

[redacted]Phone

- The level of coins in the cash box.
- Summaries of phone activity.
- Processing of credit card and calling card calls.
- Telephone vandalism and other damage.



[redacted]

Opportunity doesn't always knock...
sometimes it rings!

[redacted]

Welcome to ETS

"Smart Phone" Technology

Profitable Opportunities

The Incomparable Pay Phone

More than two million pay phones are located in airports, restaurants, malls, public facilities, hotels and conference centers, as well as many other familiar places throughout the country. Is there any other means of communication likely to replace the pay phone? While technology advances, opening new channels and devices for communication, there really is no substitute for the pay phone. It is a fundamental and relatively inexpensive link in the chain of worldwide communications and is the medium of choice for telephone calls placed outside the home and place of business.

Pay phones have emerged as an exciting business opportunity in the rapidly evolving telecommunications market and have already proved to be a reliable means of generating income. In the past, pay phones were operated with little or no profit, much like a service in the public interest. Now, all of that has changed. Deregulation has provided the opportunity for corporate and private ownership, opening the door for profits for individual pay phone owners and operators.

Why Are Pay Phones Ringing with Opportunity?

Since private owners entered the field, the pay phone industry has grown into a highly profitable venture, with revenues in excess of $9 billion in 1996 alone. Competing manufacturers have been able to focus on the development of new technologies which promote greater operating efficiencies. With increased efficiency, pay phone profits have grown dramatically, and are expected to continue to escalate, with recent legislation that provides for additional compensation to pay phone owners.

Pay phone ownership offers a unique business environment:

- **It is virtually recession-proof.**
- **It can produce revenue 24 hours a day, 365 days a year.**
- **Pay phones can offer a steady, immediate cash flow.**
- **And, it may provide significant income tax benefits.**

Very few business opportunities can offer the potential for ongoing revenue generation that is available in today's pay telephone industry.

[redacted]

"There are millions to be made from owning pay phones."
- USA Today

ETS PAYPHONES

July 1, 2000

Dear Leaseholder:

Recently, I have received several questions from our Lessors. I would personally like to take some time and answer many of those questions for you and to assure you that ETS is as strong as ever and looking forward to continued growth:

Q. Is the payphone industry slowing down?
A. No, I don't think the industry is slowing down, although it is going through a number of changes - which include a widespread use of wireless phones and 1-800 calls (dial around calls).

Q. Are payphones losing calls because of wireless phones?
A. No, when you analyze the calls made on cellular phones, most of the calls are convenience calls that would not have been made from payphones. As such, most of these calls would ordinarily be made from homes or offices. The number of call attempts from payphones is about the same as they were in 1995. The difference is the amount of 1-800 calls (dial around calls) has increased dramatically, cutting down on traditional coin calls.

Q. Is revenue down on payphones overall?
A. Yes, not because of less call attempts, but because we are only collecting about 50% monthly of what is actually owed us for these dial around calls.

Q. Will receipt of dial around compensation improve for payphone companies?
A. We certainly have strong plans in place to increase this important revenue stream. In fact, we are working very closely with the industry's top association, the APCC, (National Payphone Association) to receive our fair payment for the use of our payphones (for dial around calls), as was mandated by the FCC in 1996.

Q. What about all the bad press relating to the payphone industry?
A. If you check, most of those articles were written by the wireless industry. I feel you will see a number of positive news articles about payphones in the near future. A lot of great things are happening with payphones!

Q. How big is ETS?
A. ETS is currently the second largest independent payphone provider with over 52,000 payphones in 38 states, the Virgin Islands and Puerto Rico. We are also the largest payphone provider in Mexico.

Q. How many offices and associates does ETS currently have?
A. We have 29 offices in the USA, the Virgin Islands, Puerto Rico – and four offices in Mexico. We currently employ approximately 500 associates.

Q. Why does it take 180 days after request for liquidation of some or all of my payphones?
A. As stated in our lease contract, liquidations may take up to 180 days.

www.etspayphones.com

PLAINTIFF'S EXHIBIT 23

Q. *What happens to my lease payments after I request a liquidation?*
A. They continue on up to the day your equipment is liquidated. You never lose income on your payphone equipment.

Q. *What is ETS' involvement with the National Center for Missing and Exploited Children and the Adam Walsh Children's fund?*
A. ETS is very committed to the National Center for Missing and Exploited Children and the Adam Walsh Fund. Our main thrust is to provide "123 dialing, mandated on all payphones (similar to 911), enabling any child who could access any one of the 2.3 million payphones nationwide to call toll free to the Center. A trained counselor would then be accessed on every "123 call - 24 hours a day/seven days a week. We have received the approval and support of the entire APCC and are now working with the Bell System and GTE Coalition. Our goal is to have this service provided on every payphone in the country. We have also committed to raise $500,000 for these two Centers in 2000. We are happy to report that we are already half way toward our goal! Incidentally, we are planning to place pictures of missing children inside our new advertising panels – mounted to our existing payphones.

Q. *Is ETS still sponsoring a race car?*
A. Yes, we sponsor Tommy Ballard in car #23 in the NASCAR Goody's Dash series. The race team is donating 25% of its winnings to the aforementioned Centers. Additionally, anyone who donates one dollar or more at any race receives a free 20 minute prepaid calling card picturing our association. We have enclosed one for you with this month's check.

Q. *Can I contribute to the National Center for Missing and Exploited Children?*
A. Yes, we will be sending out more details in the near future.

Q. *Is ETS developing any new programs for its lessors?*
A. Yes, once again, we will be sending you information on these exciting new programs.

Q. *Is ETS financially stable?*
A. Yes, we made a profit of nearly $8,700,000 last year and our profit potential looks even better for this year. ETS has become the leader in the payphone industry.

Hopefully, this will answer some of your questions. You will be receiving a number of news updates and programs that ETS is involved in. There has never been a better time to be in the payphone industry.

OPPORTUNITY DOESN'T ALWAYS KNOCK, SOMETIMES IT RINGS!

Sincerely,

Charles E. Edwards

Charles E. Edwards
Chairman of the Board

"Service is our commitment.

PRO INSURANCE AGENCY, INC.

Saving and making you money is our business."

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ETS Payphones

Opportunity doesn't always knock...sometimes it rings!

Deregulation of the phone industry has made it possible for almost anyone to participate in the lucrative, multi-billion dollar payphone industry. Now ETS Payphones, Inc. makes it even easier for the novice by making available their proven management, maintenance and leasing programs.

ETS Payphones, Inc. is a payphone operating company which owns and operates its own phones with day-to-day management and computer-controlled maintenance systems.

ETS Payphones delivers... Service, Quality, Commitment!

Management Program

We will manage your phones for you if you wish to become less active in management and maintenance.

Lease Program

Under certain conditions, we will lease your phone from you and pay you a monthly rental fee. This will allow you to become detached from the day-to-day demands of the payphone business.

Management Program Requirements

Your phones must be "smart" phones.

The software must be compatible with ETS software management systems.

You furnish site and site contact with owner.

Payphone must be located in states in which ETS is operational. New territories are opening on a regular

PLAINTIFF'S EXHIBIT 24

basis.

We provide limited maintenance services for $45.00 monthly, and full maintenance services for $75.00.

Lease Program Requirements

The phone and related equipment must be new and meet ETS specifications.

Lease term of 60 months.

Introduction rental fee of $82.00 per month, totaling $984.00 per year.

Lessor is owner of equipment that may be depreciated (See your tax advisor).

Lessor (owner) options at lease-end:

1. Lessor may renew the lease at their existing lease rate.
2. Lessor may keep the phone and location and operate it
3. "Option to Sell Agreement" to purchase the payphone and location from owner at lease-end.

Please contact ETS for complete information on any of the above described programs.

The Payphone Industry

Most Cash Business

Growth Each Year

Depression Proof

Consumable Product

No Inventory

Be Your Own Boss

No Employees

Easy to Learn

Part or Full Time

ETS PAYPHONES

Atlanta, Georgia
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The Most Often Asked Questions & Answers About the ETS Payphone Equipment Lease Program:

Q. Who is ETS Payphone, Inc?

A. Ets Payphones, Inc. is the largest, privately held payphone company in the United States. ETS has annual sales in excess of $100 million and is headquarted in Atlanta, Georgia. ETS owns, leases and services "customer owned, coin operated telephones" in 32 States, Mexico and US Virgin Islands. As of June 1, 1999 ETS has a total of approximately 65,000 payphone locations.

Q. What is the ETS Payphone Equipment Lease Program?

A. The ETS Equipment Lease Program is made available to the owner and pays the owner a monthly lease payment of $82 per month, per phone, regardless of the location of the phone. The payphone owner purchases the "smart" payphones from an independent Marketing Group that will handle all the leasing arrangements with ETS. The "smart" payphone meets all the technical specifications required throughout the payphone industry.

Q. What is the cost of each "Smart" Phone?

A. The cost of each "smart" payphone is $7000.

Q. What is the equivalent yield of the lease payment that the payphone owner receives when the owner leases a payphone to ETS, and receives the $82 per month lease payment per payphone?

A. The Payphone Owner's Lease Payment is equivalent to a 14.1% return per year.

Q. Can I purchase a "Smart" Payphone directly from ETS?

A. NO! ETS is a payphone operating company and does not sell payphones. "Smart" payphones are purchased only from Independent Marketing Groups selling these payphones.

Q. What about liquidity?After the payphone owner has entered into a lease agreement with ETS, can the owner get their money back, and when?

A. Yes! ETS will purchase the payphone from the owner/lessor at anytime during the period of the lease, for the original purchase price of the phone, without any penalty.

Q. What is the normal term of the lease agreement?

A. The normal term of the lease is 5 years.

Q. What are the owner's options at the end of the term of the lease?

A. At the end of the term of the lease the owner has the following options:

1. Renew the lease with ETS at the existing lease rate.
2. The owner may choose to keep the phone on location and operate the phone.
3. ETS will purchase the phone at the end of the term of the lease from the owner for the full purchase price, without any penalty.

Q. What is the minimum number of payphones necessary to qualify for the ETS lease program?

A. The minimum number of payphones required for the ETS Lease Program is just one (1) payphone.

Q. Is the ETS Payphone Leasing Program suitable for IRAs and other pension plans?

A. Yes. The ETS payphone leasing program is suitable for IRAs and other pension plans.

Q. If I want to invest my IRA or Pension Fund Money into the ETS payphone leasing program, what should I do?

A. To invest IRA or Pension Fund Money into the ETS Payphone leasing program, you should do the following:

1. Establish a "Self-Directed IRA" account with an ETS approved administrative trust company.
2. Transfer sufficient money from your existing IRA or Pension Fund into your new "self-directed IRA" account.
3. Instruct your new "self-directed IRA" account to purchase the number of payphones you desire, and to place them into the ETS Payphone Lease Program.

Q. Is there a tax advantage to owning a Payphone (I.E.)?

A. The owner of payphone equipment may be able to depreciate the cost of that equipment (individual owners should contact their tax advisor since we do not give tax advice).

Q. Is it possible to see a sample of the lease agreement with ETS?

A. Yes. ETS will be pleased to send a sample lease agreement to each person that the agent requests the information to go to.

Q. What is the procedure to purchase one or more "Smart" Payphones and then arrange to lease them to ETS?

A. Payphone owners purchase their payphones from a Marketing Agent that sells "smart" payphone(s) and arrange for the phone(s) to be placed in the leasing program with ETS.

If an IRA or pension account is involved, the Agent can also assist to see that all paperwork is properly completed and sent to the proper people for processing.

Q. What paperwork do I receive from the company selling the payphone(s) and from ETS if I choose the ETS Leasing Program?

A. Upon receipt of your purchase agreement the company supplying the phone(s) will acknowledge receipt of your order and ship everything needed to ETS.

Q. After purchasing my payphones, when can I expect to receive my first lease payment from ETS?

A. All payphone owners can expect to receive their first lease payment 60 days after the purchase of your payphone, and their paperwork has been received and acknowledged by ETS. After the first lease payment is sent, all subsequent payments are sent monthly. Checks are sent on either the 1st and the 15th of each month.

If your payphone lease is in your "self-directed IRA" the lease payments will be sent directly to your IRA account.

Q. Does ETS provide other types of maintenance programs for payphone owners?

A. Yes. ETS provides two management/maintenance programs in addition to the equipment leasing program. However, both of these management programs are for people who wish to be involved in the day to day management of their payphones and both programs require that maintenance fees to be paid to ETS on a monthly basis. In addition neither management program is suitable or approved for IRAs or other pension funds.

ETS Payphones, Inc.

ETS payphones, Inc. is located in the following states:

- **Alabama**
- **Arizona**
- **Arkansas**
- **California**
- **Colorado**
- **Florida**
- **Georgia**
- **Illinois**
- **Indiana**
- **Iowa**
- **Kansas**
- **Kentucky**
- **Louisiana**
- **Maryland**
- **Michigan**
- **Minnesota**
- **Mississippi**
- **Missouri**
- **Nebraska**
- **New Jersey**
- **New Mexico**
- **New York**
- **North Carolina**
- **Ohio**
- **Oklahoma**
- **Pennsylvania**
- **South Carolina**
- **Tennessee**
- **Texas**
- **Virginia**
- **West Virginia**
- **Wisconsin**

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[PLAINTIFF'S EXHIBIT 25]

DECLARATION OF RANDALL WILLEY

I, Randall Willey, declare under penalty of perjury that:

1. I have personal knowledge of all the facts stated herein.
2. I am currently 75 years old. I live in St. Charles, Missouri. I am also retired.
3. I became aware of ETS Payphones, Inc. ("ETS") approximately three years ago through Bob Sewell, who worked through Communications Marketing Association, located in Boca Raton, Florida.
4. I purchased a total of 7 payphones from ETS. I purchased three payphones for $6,000 apiece and four payphones for $7,000 apiece. My total investment in those payphones was $46,000.
5. According to information received from ETS, my payphones are located in South Carolina, Georgia and Texas. However, I have never actually seen any of my payphones. None of my payphones are located near my residence in Missouri.
6. I invested my money in ETS because it appeared to be a good investment and offered a good rate of return. I did not enter into this investment with the intention of actually operating any payphones myself.

7. I leased all my payphones back to ETS. I receive monthly lease payments from ETS of approximately $82 per payphone.

8. I signed an agreement with ETS in which ETS promised to buy back my payphones within 180 days at my request.

9. I have always received my monthly lease payments from ETS. I have not yet exercised any buyback agreements.

10. I do not manage any of my payphones nor do I intend to ever manage any of my payphones. In fact, I do not possess the expertise to manage payphones. All my payphones are managed by ETS.

11. Neither ETS nor any of its representatives have ever informed me, either before or after making my investment, that the receipt of my monthly lease payments is dependent on the sale of payphones to new ETS investors.

12. Neither ETS nor any of its representatives have ever informed me, either before or after making my investment, that ETS payphone operations are not profitable.

13. In January 2000, I attended a meeting in Boca Raton, Florida at which Charles Edwards, the Chief Executive Officer of ETS, spoke. At that meeting, Mr. Edwards stated that ETS was profitable. He specifically stated that the income earned from payphone operations and advertising was sufficient to offset the cost of operations.

14. Neither ETS nor any of its representatives have ever informed me, either before or after making

my investment, that if a significant number of investors decided to exercise their options to sell their payphones back to ETS, that ETS did not have the available financial resources to satisfy its obligations.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct.

Executed this 22 day of September 2000.

/s/ RANDALL WILLEY
RANDALL WILLEY

IN THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. 1:00-CV-2532

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES INC., AND CHARLES E. EDWARDS,
DEFENDANTS

DECLARATION OF CHARLES E. EDWARDS

1.

I, CHARLES E. EDWARDS, am over the age of eighteen and am competent in all respects to make this Declaration. This Declaration is made and presented in support of the "Opposition of Defendant Charles E. Edwards To Plaintiff's Application for Preliminary Injunction, Asset Freeze, and Other Equitable Relief," submitted on my behalf in the above-referenced action.

PERSONAL BACKGROUND AND INFORMATION

2.

I am the controlling shareholder, the current Chairman of the Board, and, until early 2000, I was the Chief Executive Officer, of ETS Payphones, Inc. ("ETS"), a Georgia corporation. James Blyth is now the President and Chief Executive Officer of ETS. ETS filed a voluntary petition under Chapter 11 of the Bankruptcy Code on September 11, 2000, in Delaware. The lead debtor in

the bankruptcy proceeding is Payphone Systems Acquisitions, Inc. ("PSA"), a Delaware corporation and wholly owned subsidiary of ETS. ETS' decision to voluntarily file its bankruptcy petition, and its proposal for settlement of the instant matter as preliminarily agreed to by the Securities and Exchange Commission (the "SEC"), is discussed in greater detail below.

3.

I am 62 years old. I have been married for 17 years, and my wife and I have lived in the Atlanta area continuously since 1989. After graduating from high school, I served four years in the Air Force. Since that time, I have been involved in a number of businesses, including, since 1989, the telecommunications business.

4.

I began in the pay telephone business in about 1993 by serving as marketing director for Global Communications, a company that, among other things, sold pay telephones to end users. In 1994 I formed ETS; it was incorporated in Georgia. At its inception, ETS sold and managed pay phones, engaging in 22 sales and lease agreements in 1994. In September of 1995 a company then related to ETS received a letter from the SEC, a copy of which is attached as *Exhibit 1*. As described in more detail below, in 1995, the SEC conducted an informal inquiry of my pay telephone business. As a result of the SEC's investigation, I participated in several meetings with the SEC during which ETS' attorney and I were provided suggestions by the SEC lawyer on how to conduct the business to avoid running afoul of the SEC laws and rules. I made several fundamental changes to the business in a good faith effort to comply with the letter and spirit of the SEC's

suggestions. One of the changes, was to set up a new wholesale telephone company, and use the services of independent distributors who would, separate from ETS, market pay telephones.

5.

In addition to ETS and its wholly owned subsidiary, Payphone Systems Acquisitions, Inc. ("PSA"), I am currently the controlling shareholder, directly or indirectly, of a number of other business concerns which support the business of ETS, including: (1) Twinleaf, Inc., which provided management and consulting services to ETS and PSA based upon a flat fee payment per telephone sold; (2) Legends Communications, Inc., which provided switch-based long distance telephone services to ETS managed payphones and ETS facilities; (3) TPL, Inc., which manufactures prepaid calling cards and printing for ETS; (4) Twinleaf Media, Inc., which owns patent rights to and markets an advertising kiosk for payphones; and (5) Axis, Inc., which holds patent rights to and markets a three-dimensional advertising concept for various locations, including payphones. Twinleaf also owns IAQ Duct Doctor, Inc., which is in the business of cleaning and servicing heating and air conditioning ductwork.

6.

I have no intention of engaging in the pay telephone business with any business other than ETS. I have no intention of engaging in any business involving the sale of securities unless and until questions regarding ETS are resolved.

7.

I have an ongoing interest in and am dedicated to various charitable community issues. Included among my efforts in this regard is work and contributions to the Atlanta Union Mission over the past three years and a national program that I have spearheaded through ETS. This is a program for lost or missing children called "Star 1, 2, 3." This program, established in conjunction with the American Public Communication Counsel and the National Center for Missing and Exploited Children, will enable lost, missing or kidnapped children anywhere in the nation to be able to pick up a public payphone at any time and dial "Star 1, 2, 3" which will put them directly in contact with a private counselor trained to deal with such situations. I am a Board Member of the International Center for Missing and Exploited Children.

ETS'S STRUCTURE AND OPERATIONS

8.

ETS, during all times relevant herein, was engaged in the business of operating coin operated pay phones for a profit. The phones are primarily customer-owned, coin/coinless-operated telephones ("COCOTs"), although ETS also operates phones that are not owned by third parties.

9.

ETS is the largest privately owned payphone operator in the United States and one of the top three largest payphone companies in the United States. ETS currently operates, maintains or services tens of thousands of payphones in thirty-eight states throughout the continental United States, Puerto Rico, Mexico and the

Virgin Islands. ETS has one phone in Canada. ETS employees over 440 people, operating out of 32 offices located throughout the United States and four offices in Mexico.

10.

PSA, ETS's wholly owned subsidiary, purchases telephone equipment and locations for payphones and then sells the equipment and location (the "COCOT Interest") to independent marketing organizations (the "Distributors"). These Distributors, in turn, sell COCOT Interests, among other products, to individuals and others who want to own a COCOT Interest (the "COCOT Owners"). The primary Distributors include: B.E.E. Communications (now known as BCI), located in Cartersville, Georgia; Hayes Communications, located in St. Petersburg, Florida; and National Communications, located in Boca Raton, Florida. I have no ownership or control over any of these Distributors.

11.

ETS has no knowledge about the identity of persons who may be offered purchase opportunities by the Distributors for COCOT Interests or other products. When the Distributors sell the COCOTs, the Distributors provide their own information packages describing the owner's options for operating the COCOT. These options might include, for instance, operating the phone themselves; placing the phone with a management company; or leasing the COCOT Interest to a payphone operator, including, but not necessarily limited to, ETS. There are numerous other companies that provide payphone management services, including one larger than ETS and several others that service more than 10,000 payphones.

12.

Before 2000, Distributors were not allowed to make any representation on behalf of ETS or its programs, but instead directed the COCOT Owner as how to obtain additional information from ETS. Once contacted by a COCOT Owner, ETS would then handle all paperwork and negotiations with any COCOT Owner interested in a relationship with ETS. Beginning in 2000, in those states where the Distributors were registered under Business Opportunity laws, the Distributor was allowed to provide ETS materials to an interested COCOT owner.

PSA'S ACQUISITION OF PAY TELEPHONE EQUIPMENT AND LOCATIONS AND THE COSTS THEREOF

13.

PSA uses three methods of acquiring payphones for sale to Distributors: (1) the purchase of payphones in operating locations from existing owners; (2) the purchase of payphone components from equipment wholesalers, which PSA then assembles into complete units; and (3) the purchase of complete payphones from manufacturers. The first method is the most common. In substantially all cases, either the complete payphone or at least the basic electronic components are products of one of three manufacturers: Elcotel, Protel or Intellicall.

14.

During 1999 and 1998, approximately 90% and 70%, respectively, of the payphones acquired by PSA were acquired in locations from existing owners, with the

remainder of 10% or 30%, respectively, being purchased from either manufacturers or equipment wholesalers.

15.

Although each purchase of a payphone already situated in a specific location is individually negotiated with the seller, the following are general principals used in valuation when PSA purchases payphones in existing locations:

a. PSA determines all sources of revenue which includes coin, long distance, dial-a-round (800 numbers), intra-Lata (local areas prescribed by the local phone company), credit card calls, 1-800 collect calls, advertising, etc.

b. PSA subtracts certain costs such as the phone line plus the payments to the location owner, taxes and any local license fees. PSA considers the monthly revenue less such costs to be the "gross net."

c. PSA pays for the typical payphone already situated in a specific location approximately 30 times the monthly gross net, although multiples have ranged generally from 24 to 36 times the gross net, based on terms of the location lease, the number of units involved in the purchase, the desirability to PSA of particular locations, the age and condition of the equipment (which can vary the value by plus or minus 5%), and other factors.

16.

PSA's acquisition program depends on market conditions and transactions available at the time, but the

following is a general description of the economics based on recent conditions:

a. Before September 1999, the average price paid by PSA for a payphone in location was approximately $3,787 and that cost has not materially changed;

b. After a phone route is purchased, PSA either upgrades or totally replaces the payphone equipment for an additional average cost of approximately $1,200 per phone, resulting in an overall cost of approximately $4,987 per phone in location purchased;

c. In addition, approximately 20% of the payphones acquired existing locations will need to be moved to a new location, resulting in a further approximate $1,200 cost for the units that are moved.

17.

When PSA installs a payphone at a new location, it generally incurs the following costs:

EQUIPMENT	COST
Smart Phone-average (current range is approximately $930 to $1,100)	$1,000*
Enclosure and Pedestal	350
Mast Pole and Signs	75
Misc. (Bolts, Wires, etc.)	25
Signing Bonus paid to location owner–average (current range is approximately $50 to $1,500)	400

Payment to the locator–average (current range is approximately $150 to $400)	300**
Concrete Pad	300
Labor	300
TOTAL	$2,750

* Assumes payphone is newly purchased from manufacturer or wholesaler; if purchased in location, total cost approximates $5,000, as described above, and some of the foregoing costs are avoided.

** Most locators are independent contractors (not affiliated with Distributors). Some are employees of PSA.

18.

Approximately 30% of all new installations will not develop sufficient revenue to meet expenses, requiring a relocation of the phone to another new location, resulting in an additional cost of approximately $1,200 per phone.

19.

PSA normally must support each new installation for approximately six months before it becomes profitable.

20.

As a result of the above-described factors, the average total cost of a newly installed phone to reach break-even is estimated at close to the same as the overall amount which is expended when phones already situated in a specific location are purchased.

21.

Initially, ETS sold payphones for $3,600 to the Distributor, with a suggested resale price of $4,500. Over the years the price has increased. Most recently, PSA typically sold payphones to Distributors for $5,250, with a suggested resale price from the Distributor to the Purchaser of $7,000, although PSA does not participate in that transaction.

22.

Once a payphone is purchased by PSA from a manufacturer or wholesaler, PSA must perform the following to each payphone before it can be placed in service, adding to the payphone's value: (1) find a location for the unit; (2) negotiate and document appropriate arrangements with the location owner; (3) pay commissions to the locator; (4) order, purchase and install the payphone and ancillary equipment; (5) if necessary, make the front end payment to the location owner; (6) program and set the internal parameters of the payphone; (7) contract with the long distance carrier; (8) order a payphone line from the local carrier; (9) test the units; (10) obtain any necessary licenses from regulatory bodies; and (11) create appropriate records and controls.

ETS MANAGEMENT OPTIONS
FOR PAY TELEPHONES SOLD BY DISTRIBUTORS

23.

When a Distributor attempts to sell payphones, the Distributor, among other options, presents the availability of the ETS management options to the prospective COCOT Owner, and advises the prospective COCOT Owner how to obtain additional information

from ETS. Where permitted by Business Opportunity Law, the Distributor may present the ETS disclosure document.

24.

If a COCOT Owner thereafter initiated contact with ETS, ETS then provided the COCOT Owner with information regarding the three options available for management/lease of the payphone.

25.

The sale of the payphone by the Distributor to the COCOT Owner did not employ high- pressure sales tactics. The purchase agreements used by the Distributors generally provided for a fifteen (15) day cancellation period at the election of the COCOT Owner.

26.

Moreover, in a typical transaction, a period of time (from several days to up to several weeks) passed before the COCOT Owner receives any written information about the services offered by ETS, including the Payphone Program involving the lease and option to sell arrangements. Once the COCOT Owner received the information from ETS, he or she was free to consider it in consultation with any other person, including attorneys, accountants, or other financial advisers. In fact, the materials prepared by and delivered to COCOT Owners by ETS specifically *encouraged* COCOT Owners to "read all of the lease carefully, and take time to decide if it is right for you. If possible, show your lease to an advisor (i.e., a lawyer CPA, etc.)."

27.

The materials provided by ETS to COCOT Owners upon their request presented three options for payphone management.

28.

Under Option I, the "Internal Maintenance Program," the COCOT Owner engages ETS to perform certain installation, maintenance and management services for the COCOT Owner's phone. Under this option, ETS does not find locations for operation of the payphones, secure agreements with the locations' owners, or collect the revenue generated therefrom. The standard fixed fee for these ETS services is approximately $45 to $65 per month per COCOT, depending on the location.

29.

Under Option II, the "Turnkey Maintenance Program," PSA obtains a site location for each of the COCOT Owner's payphones, and ETS performs a more comprehensive range of services for the COCOT Owner, including collection, counting, bagging and depositing all coins. ETS's fixed fee for this service is approximately $75 per month per payphone. Under this option, the owner retains all revenues from the payphone.

30.

Under Option III, the "Payphone Equipment Lease Option" (the "Lease Program"), the COCOT Owner leases the COCOT to ETS and ETS assumes full responsibility for all aspects of their placement, maintenance, operation, etc. The location for each payphone is selected by computer from a general database of locations.

31.

Under the most recent Lease Program, ETS pays the COCOT Owners a fixed rental rate of $82 per month per payphone, and ETS retains all revenues generated by the leased payphone. Certain other COCOT Owners receive a fixed rental rate of either $75 or $80 per month per payphone. The monthly rate varied depending on when the COCOT Owners entered into the ETS Lease Program. The rental payments increased with regard to the retail price of the phone (e.g., COCOT Owners received either $75 or $82 per month per payphone, respectively, compared to the then retail value of the payphones of either $4,500 or $7,000). The COCOT Owner has no benefit or risk relating to the profitability or performance of the COCOTs, but receives only a fixed net monthly rental from ETS.

32.

The vast majority of COCOT Owners who do business with ETS do so under the Lease Program, with the option to sell the payphone to ETS (collectively, the "Payphone Program").

DETAILS OF THE PAYPHONE PROGRAM

33.

Under the Payphone Program, in effect for all leases entered into prior to February, 2000, ETS gives the COCOT Owner an option to sell the payphone to ETS prior to or upon expiration of the lease term for a fixed price equal to the original price per payphone, with no penalties for early termination of the lease. A true and correct copy of an ETS Equipment Lease Agreement entered into prior to February, 2000, is attached hereto as *Exhibit 2*.

34.

Specifically, under the Payphone Program, in effect for all leases entered into subsequent to February, 2000, ETS gives the COCOT Owner an option to sell the payphone to ETS prior to or upon expiration of the lease term for a fixed price as follows:

a. At any time between the nineteenth month of the lease term and prior to the completion of the sixtieth month of the lease term, for the purchase price (currently $7,000) less the monthly rental times twelve;

b. Subsequent to the completion of the sixtieth month of the lease term for the purchase price (currently $7,000).

35.

A true and correct copy of an ETS Equipment Lease Agreement entered into after February, 2000, is attached hereto as *Exhibit 3*. This change was made because we discovered that some of the Distributors' agents were encouraging COCOT owners to sell their phones and buy new ones merely to generate sales commissions.

36.

Upon termination of the lease under Option III, the COCOT Owner may renew its lease with ETS, cause ETS to purchase the payphone, or take control of the payphone with the possibility of selling the payphone, leasing it to, or entering into a management agreement with another operating company, or self-managing the payphone.

37.

ETS has always attempted to provide potential COCOT Owners with sufficient information about ETS and its officers to ensure they make an informed decision. For example, attached hereto as *Exhibit 4* is a true and correct copy of disclosure documents provided by a registered Business Opportunity Distributor to COCOT Owners, which contains the disclosure documents provided by and regarding ETS, compiled by ETS in accordance with the Federal Trade Commission disclosure regulation rules.

RELIANCE ON ADVICE OF PROFESSIONALS AND SEC STAFF SUGGESTIONS

38.

ETS started the Lease Program in 1994. ETS expended considerable resources engaging various attorneys to provide not only guidance on the structuring of the debt-financing of the Lease Program, but the continued operations of ETS. ETS began, and maintained, its Lease Program with the understanding that it was not involved in the sale of a "security." Attached as *Exhibit 5* is a copy of a 1996 opinion of counsel. Attached as *Exhibit 6* is a 1998 opinion of counsel. Each of these counsel advised ETS that the Payphone Program sales do not constitute the offer or sale of securities. In 1997, I learned that the Sixth Circuit Court decided a case that ruled that pay phones utilized in a sale, lease-back, buy-back program did not involve the sale of securities. I read the Court's opinion and relied on what it said as stating the law. I had no reason to believe that these opinions of counsel and this Court opinion were inaccurate in any way or a misstatement of the law.

39.

I also relied, in part, on discussions with attorneys, and a draft opinion letter from, the law firm of Powell, Goldstein, Frazer & Murphy LLP ("Powell Goldstein"). A copy of the draft opinion letter dated July 30, 1999, is attached as *Exhibit 7*. Powell Goldstein similarly advised ETS that the Payphone Program sales do not constitute the offer or sale of securities.

40.

My understanding that the Payphone Program sales do not constitute the offer or sale of securities was also based, in part, on the recommendations regarding the corporate structure of ETS's operations received during meetings with the SEC Staff in Atlanta in 1995. In 1995, the SEC Staff of the Atlanta office performed what was explained to me as an "informal investigation" of ETS and its operations. As part of this investigation, I met, along with Sheldon Friedman, an attorney engaged on behalf of ETS, with an SEC lawyer, Larry Grant. I explained to Mr. Grant, as I explained to the SEC during my later testimony in March 2000, that I have always been willing to undertake all actions necessary to ensure that ETS was operating properly and in accordance with all applicable laws.

41.

In addition, I showed to Mr. Grant the then-current financial statements of ETS.

42.

At the time of my meetings with Mr. Grant in 1995, ETS and the predecessor to PSA, Inter-Net, were directly involved in both the marketing and leasing

aspects of the business. During the course of these meetings with Mr. Grant, Mr. Grant recommended to me that ETS divest itself from the direct marketing and/or leasing aspects of the business and that ETS give more control over the payphones to the COCOT Owners.

43.

As a result of, and relying on, the recommendations received from Mr. Grant, I initiated the restructuring of the business operations of ETS and assisted in the start up of certain Distributors to ensure that ETS was removed from the direct marketing of the Lease Program. In addition, in order to provide the COCOT Owners with more control, I initiated the implementation of the liquidation option for owners to be enable them to sell their payphone(s) to ETS during or at the conclusion of their payphone lease terms.

44.

Following the 1995 "investigation" of ETS, I did not hear from the SEC again until 2000—some 5 years after their initial investigation.

45.

My understanding that ETS was not involved in the sale of "securities" was further reinforced from the review of opinion letters received from Phoenix Telecom, LLC ("Phoenix"), a corporation discussed further below, regarding this exact issue. Attached as composite *Exhibit 8*, are examples of opinion letters received by Phoenix regarding the propriety of its operations.

46.

My understanding that the Payphone Program sales did not constitute the offer or sale of securities was reinforced by the decision of the state securities regulators in Massachusetts, which found that the ETS Payphone Program sales were not securities. "Memorandum of Decision and Order," Securities Division of the Commonwealth of Massachusetts, *In the Matter of Frances A. Rahaim Financial Services*, No. E-2000-22, Securities Division, Office of the Secretary of the Commonwealth of Massachusetts (July 11, 2000). A copy of this decision and order is attached as *Exhibit 9*.

GAAP VS. NON-GAAP FINANCIAL ACCOUNTING CONVENTIONS

47.

ETS does not employ accounting conventions known as "Generally Accepted Accounting Principals" ("GAAP") because it is not required to do so and because ETS management believes that non-GAAP financial statements more appropriately measure the company's financial performance.

48.

Accordingly, ETS prepared and maintained financial information (including income statements) in non-GAAP format. As part of its normal accounting practices, ETS *did* finalize its year-end statements of financial information, including income statements, in that format. The ETS "Statement of Income for the Twelve Months Ending December 31, 1999," attached as page 2 of Exhibit 3 to the Affidavit of Robert Lough (filed by the SEC in support of its Application for Preliminary Injunction, Asset Freeze, and Other Equitable

Relief) is a *preliminary, draft* Statement of Income. Attached as *Exhibit 10* to this Declaration is a true and accurate copy of the final version of the ETS "Statement of Income for the Twelve Months Ending December 31, 1999."

49.

There are significant differences between the financial statements conforming to GAAP and those which are not prepared in accordance with GAAP, which are discussed below.

50.

Under GAAP, the financial statements treat the leased payphones as assets of the company, being acquired by it under a financing arrangement, although the COCOT Owners hold legal title to their payphones and may never elect to sell them to the Company. The payments made by the company under lease agreements are treated as interest expenses and the underlying leases are treated as capital leases.

51.

In the GAAP financial statements, the company's liabilities include $164.4 million that would become due to the COCOT Owners if all of them exercised their sale options. If a COCOT Owner exercises the sale option, the amount paid by the company is recorded as a reduction in the liability.

52.

In addition, the GAAP financials value the company's payphones at their historic cost, less depreciation. The company believes that the current fair market value, for which many of the payphones could be liquidated promptly, exceeds their carrying value on the GAAP

statements. Thus, this unrealized appreciation is not reflected in the GAAP financial statements.

53.

In contrast, under non-GAAP accounting conventions, the payphones leased by the company are treated as assets of the COCOT Owners and not the company. Therefore, the Company does not treat depreciation of the payphones as a company expense and does not claim a tax deduction for such depreciation on its tax return. The COCOT Owners get that tax benefit.

54.

Under non-GAAP accounting standards, the payments made by the company under the lease arrangements are treated as rental expense in the financial statements and the underlying leases are treated as operating leases. If a COCOT Owner exercises the sale option, the amount paid by the company is recorded as an expense in the company's results of operations when paid and the payphone becomes a company asset.

55.

Importantly, under non-GAAP accounting methods, revenues from the sale of payphones are recognized in the company's results of operations when proceeds have been received from the Distributor.

56.

The resulting differences in treatment in financial statements prepared under GAAP versus non-GAAP are that in 1999 (for example), under GAAP, the company incurred a $26.8 million loss whereas under non-GAAP, the company showed net income of $8.7 million. The principal reason for these differences is the treat-

ment of the revenue from Payphone Program sales (decreasing revenue from that stated in non-GAAP financial statements by $118.7 million) and the sale option given to COCOT Owners (increasing liabilities from that stated in non-GAAP financial statements by $164.4 million).

57.

Accordingly, assuming that any statements were made (and are properly attributed to ETS or to me personally) that the financial condition of ETS was positive, these statements were neither inaccurate nor misleading given that ETS was an operating company that did not keep records in accordance with GAAP accounting conventions, and paid taxes and monitored performance on that basis.

58.

The SEC has pointed to an ETS brochure that addresses how payphones can be profitable. The description in the brochure is of a single payphone. It does not address and was not intended to describe the profitability of a payphone management such as ETS.

59.

The SEC has repeatedly used the term "Ponzi scheme" to describe ETS's business. As has been explained to me, a Ponzi scheme is a scheme in which there is no real business and newly invested money is used merely to pay off old investors and convince them that they are "earning profits rather than losing their shirts." The ETS payphone business is not a Ponzi scheme. ETS and PSA used revenues raised by the sale of payphones to purchase phones and locations and ETS expected that its revenues from the operation of

the payphones would increase over time until ETS no longer needed to utilize revenues from individual payphone sales to support its other operations.

THE PHOENIX ACQUISITION

60.

On or about July 17, 2000, ETS Management Services, LLC ("ETS Management"), a wholly owned subsidiary of ETS, acquired the payphone business of Phoenix Telecom, LLC ("Phoenix") by entering into an asset purchase agreement and a management services agreement with Phoenix. Attached are true and correct copies of the asset purchase and management services agreements as *Exhibits 11 and 12* respectively.

61.

The impetus for the ETS/Phoenix transaction was to provide some protection for the Phoenix lessors concerning their executory lease agreements with Phoenix and which would in no way assure the Phoenix lessors' ability to enter a new lease with ETS. ETS's motivation for the transaction was also to avoid, or at least, to minimize, any negative impact on the public communications industry which could have resulted in a cataclysmic failure of the independent payphone provider network. In addition, ETS management, including me, believed that an expanded network would enhance ETS's possibilities for growth and prosperity pursuant to its business model.

62.

Under the management agreement, Phoenix's payphones were to remain operational and in compliance with state and federal utility regulatory requirements

during implementation of the ETS/Phoenix business transactions. Pursuant to the terms of the management agreement, ETS Management was to manage the day-to-day operations of the Phoenix payphones until new leases with ETS could be executed or alternative instructions obtained from Phoenix lessors.

63.

Pursuant to the asset purchase agreement, ETS Management acquired Phoenix's assets, identified in particular on the schedules attached thereto. In addition, ETS Management assumed certain liabilities of Phoenix and agreed to assign payphones to all Phoenix lessors who had yet to be assigned a payphone.

64.

Importantly, ETS agreed to offer Phoenix lessors the opportunity to enter into the ETS Lease Program with lease payments by ETS commencing July 1, 2000, the date on which Phoenix began missing lease payments. If all Phoenix lessors were to execute an ETS lease, ETS would have paid $1,080,000 in July lease payments as consideration for the assets acquired. ETS has paid more than $2,800,000 in lease payments to former Phoenix lessors.

65.

Prior to the acquisition of Phoenix by ETS, from approximately 1997 to December 1999, I personally acted as a consultant to Phoenix. As compensation for my role as a consultant to Phoenix, Phoenix agreed to pay me personally (and not ETS or any other corporate entity) $100 for every payphone lease agreement entered into by Phoenix. In fact, I received only about

one-half of the compensation promised by Phoenix for my consultation services.

PAYMENTS AND LOANS MADE BY ETS

66.

The SEC has alleged that I have personally taken "at least $14 million out of ETS through loans and fees paid to companies controlled by" me (Complaint, ¶ 49), which figure allegedly includes transfers in the form of loans of more than $11,600,000 to affiliates (SEC Brief, p. 9) and management fees on Payphone Program sales in excess of $3 million (SEC Brief, p. 9). In fact, there were funds loaned to Twinleaf by PSA, which, as of September 30, 2000, amounted to approximately $7.4 million.

67.

The SEC implies that these fees and loans were illegal or for the purpose of funneling the COCOT Owners' funds to me personally. These contentions are absolutely untrue. The loans made and management fees paid by ETS and PSA to various companies affiliated with ETS and/or controlled by me were accounted for in the records of the companies and were for legitimate business reasons, in the most part to support ETS's operations.

68.

For example, PSA did not perform the administrative function associated with payphone sales cash management. These functions were provided by Twinleaf. Twinleaf maintains computers, office equipment, document storage facilities and employs data entry personnel and accounting clerks, who perform the function

for PSA. Twinleaf also monitors lease payments to COCOT Owners. In addition, Twin Leaf provided the administrative, managerial, and consultation services of myself, Joel Geer and Joan Shepler, among others, with regard to PSA acquisitions, legal services, and other issues involved in the Payphone Programs, which services were rendered for the benefit of ETS and PSA.

69.

In return for performing these administrative and consulting services, since January 1, 1999, ETS/PSA has paid Twin Leaf a one-time management fee of $250 for each payphone sold by PSA (the fee was $125 per phone prior to that time).

70.

This one-time management fee represented the only managerial fee paid for the indefinite duration of the ownership of the payphone by a COCOT Owner.

71.

Each of these loans is properly reflected on the books and records of PSA and the companies receiving the loan. Given PSA's bankruptcy proceeding discussed in more detail herein, the loans are now assets of PSA, which are governed and protected by the bankruptcy court.

72.

I have submitted a stipulation on behalf of myself and Twinleaf to the Bankruptcy Court to liquidate the loans to Twinleaf in that forum. A copy will be provided to the Court.

THE BANKRUPTCY FILING OF ETS AND PSA

73.

The advent of and explosive growth in the use of both cellular telephones and the "1-800-Dial-Around" market has had a dramatic impact on ETS's business over the last two years. I estimate that the introduction of these enterprises into the market has reduced the profitability of individual payphones by as much as 25% or more. The introduction of the various companies by Twinleaf to support ETS was designed to offset these revenue losses.

74.

Despite the best efforts of ETS and PSA, as a result of these factors described above and other factors not within the control of ETS and PSA management, including independent market forces and the cost of certain litigation in New York over a claim to an ownership interest in ETS (not involving and unrelated to COCOT Owners), the business of ETS and PSA has experienced a significant downturn.

75.

On September 11, 2000, ETS and PSA filed for the protection of the Federal Bankruptcy Court in Delaware under Chapter 11 of Title 11 of the U.S. Code.

76.

I understand that a Creditors' Committee has been appointed by the Court and that ETS and PSA have met with the Creditors' Committee to discuss the status of the case and the plan for emerging from bankruptcy. ETS and PSA are working with the Creditors' Committee to develop a plan of reorganization.

THE PHOENIX ORDER

77.

On Monday, August 14, 2000, the Honorable Judge Jack T. Camp, United States District Judge, entered an Order in the case of *SEC v. Phoenix Telecom, LLC*, Civil Action File No. 1:00-CV-1970-JTC (N.D. Georgia). The Court found, among other things, that the payphone program sales of Phoenix Telecom were securities and entered a preliminary injunction and other relief sought by the SEC.

78.

Because ETS is engaged in a similar business using a similar business model (sale/lease/purchase options of payphones) and the order had obvious impact on ETS's opinions of counsel that its Payphone Program did not involve the offer or sale of securities, ETS voluntarily ceased all Payphone Program sales. This voluntary cessation of sales remains in effect pending a decision in the case filed by the SEC against ETS and me also in the Northern District of Georgia.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 11 day of October, 2000.

/s/ CHARLES E. EDWARDS
CHARLES E. EDWARDS

Telephone Equipment Lease Agreement

Lease Number: 10423

THIS AGREEMENT is made and entered into this 15th day of December, 1999, by and between ETS Payphones, Inc., a Georgia corporation (hereinafter as "LESSEE") and THOMASINA MARSELLA (Individual) (hereinafter "LESSOR").

Witnesseth:

WHEREAS, LESSOR, as owner of three (3) unit(s) of the telephone EQUIPMENT described on Exhibit A, attached hereto and by reference made a part hereof (the "EQUIPMENT") desires to lease said EQUIPMENT to LESSEE and LESSEE desires to lease said EQUIPMENT from LESSOR, all upon the terms and subject to the conditions hereinafter set forth.

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for good and valuable consideration, the receipt and sufficiency whereof are hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. **LEASE OF EQUIPMENT.** Subject to the conditions herein, LESSOR hereby leases the EQUIPMENT to LESSEE and LESSEE hereby leases the EQUIPMENT from LESSOR.

2. **TERM.** This lease shall commence (the "Commencement Date") as of the date provided above and shall remain in full force and effect for an Initial Term of sixty (60) months thereafter (the "Initial Term"). Upon the expiration of said Initial Term, this lease shall be automatically renewed, for an additional Renewal Term of sixty (60) months (the "Renewal Term") unless at least ninety (90) days prior to the end of the Initial Term, either party gives written notice to the other that said party elects not to continue during the Renewal Term. The Initial Term and the Renewal Term are hereinafter collectively deemed the "Term" of this lease. The monthly rent payment for the EQUIPMENT during such Renewal Term shall be the same as the existing rate under the Initial Term. Should LESSOR choose to terminate this lease and take possession of the EQUIPMENT and LOCATION prior to the lease expiration, LESSOR may do so with a ninety (90) day written notice.

3. **RENT.** LESSEE shall pay monthly rental to LESSOR for the EQUIPMENT at the rate of $82.00 per month per unit. The first monthly rental payment shall be due on the "Commencement Date." All subsequent monthly rental payments shall be due on the 1st or 15th day of each succeeding calendar month in accordance with the "Commencement Date" through the Term hereof.

   Note: LESSOR Rental checks shall be sent out by U.S. Mail and shall be sent on the 1st or 15th day of each month. However, should the 1st or 15th of the month fall on a Saturday or Sunday, the checks shall be sent the following Monday.

4. **TITLE.** This Agreement creates a lease of the EQUIPMENT. Nothing contained herein shall be deemed or construed as enabling LESSEE to acquire the right, title or interest in the EQUIPMENT or LOCATION, except as set forth in Sections 15 and 16 hereof.

5. **NET LEASE.** Except as expressly provided herein, the parties hereto expressly agree to and acknowledge that this is a "Net Lease" requiring LESSEE to bear the entire cost of using the EQUIPMENT and LOCATION through the Term of this lease. LESSEE shall be responsible for, and shall pay all expenses of, insurance, repair, service and maintenance of the EQUIPMENT and of the

EXHIBIT 1

LOCATION. LESSEE may, at LESSEE's expense, contract with third parties to provide such repair, service and maintenance.

6. **LOCATION.** The location of the EQUIPMENT shall be set forth on Exhibit A. LESSEE shall be responsible for selecting the location for installation of the EQUIPMENT. Lessee has the right and sole authority to move EQUIPMENT to a new location should the original location prove to be unprofitable or prove to be in a high vandalism area. LESSOR will be notified in the event of site exchange and will receive notification of the address of the new location. LESSEE shall assign the applicable location lease to the LESSOR by a written letter of assignment between the parties. In the event that LESSOR terminates the lease prior to the expiration of the Term and elects to retain the EQUIPMENT, LESSEE shall assign the applicable location lease to the LESSOR by a written letter of assignment between the parties; otherwise LESSEE shall retain the rights to the location.

7. **INDEMNIFICATION AND INSURANCE.**

a. LESSEE shall indemnify and hold LESSOR harmless from and against any and all loss, damage, liability and expense (including, without limitation, reasonable attorney's fees) which LESSOR shall sustain as a result of (i) the loss of or damage to the EQUIPMENT because of fire, theft, collision, lightning, flood, windstorm, or any other casualty at any time during the Term hereof, or (ii) the death of or injury to any person or damage to any property as a result, in whole or in part, of the use or maintenance of the EQUIPMENT at any time during the Term of this Lease.

b. LESSEE's obligations pursuant to Section 7a above shall be deemed satisfied if LESSEE obtains and maintains in full force and effect throughout the Term hereof, at the sole cost and expense of LESSEE, a policy or policies of insurance issued by an insurer reasonably satisfactory to LESSOR, with premiums prepaid thereon, insuring LESSEE against the risks and hazards specified in Section 7a(i) hereof with minimum coverage of $100,000 for property damage ($5[illegible]0,000 for the death of or injury to any one person) and $2,000,000 for any one accident or occurrence.

c. LESSEE's failure to obtain the insurance coverage specified in Section 7b hereof shall not affect LESSEE's obligations under this lease. The loss of, damage to or destruction of the EQUIPMENT shall not terminate this Lease; nor to the extent that LESSOR is actually compensated by insurance paid for by LESSEE, as herein provided, relieve LESSEE from LESSEE's liability hereunder. Should LESSEE fail to so procure or maintain the insurance required under this Section 7, then LESSOR shall have the option, but not the obligation, to procure or maintain such insurance coverage for the account of LESSEE, and in that event, LESSEE shall reimburse LESSOR within seven (7) days after receipt of any invoice for any payment made therefore by LESSOR. Failure to so reimburse LESSOR shall be deemed a default under the terms of Section 10 hereof.

8. **TAXES AND OTHER CHARGES.** LESSEE shall pay, when due, any and all use taxes, personal property taxes and any and all other taxes which may be imposed by the ownership, possession, use or operation of the EQUIPMENT at any time during the Term hereof or which are levied against or measured by the gross receipts delivered to LESSOR as a result of the payment of rent by LESSEE hereunder.

9. **USE, OPERATION, ALTERATIONS AND ADDITIONS.** The EQUIPMENT shall at all times during the Term hereof be under the sole and absolute control of LESSEE, subject to the rights of LESSOR in the event of a default by LESSEE as provided herein. LESSEE shall comply

with any and all laws and regulations applicable to the operation of the EQUIPMENT, and shall be solely responsible for the payment of any and all fines or penalties resulting from its failure to comply therewith. LESSEE shall maintain the EQUIPMENT in good working order at the location identified on Exhibit A, attached hereto, at all times throughout the Term hereof or at any other location where the EQUIPMENT may have been relocated. LESSEE may from time to time add further parts or accessories to the EQUIPMENT, provided any such addition does not materially affect or materially impair the value of the EQUIPMENT. Any such additions shall become the property of the LESSOR.

10. **DEFAULT AND REMEDIES**

a. **DEFAULT.** The occurrence of any one of the following events shall constitute an event of default by LESSEE:

1. A default by LESSEE in the payment of any amount due hereunder as and when the same shall become due and the continuance of such default for a period of more than twenty (20) days following LESSEE's receipt of written notice of such default requiring the same to be cured; or

2. A default by LESSEE in the performance of any of its material obligations under this Lease and the continuance of such default for a period of more than thirty (30) days following LESSEE's receipt of written notice of such default requiring the same to be cured; provided, however, that if more than thirty (30) days are reasonably required in order to cure any such default, then no default shall be deemed to have occurred so long as the curing of such default is commenced by LESSEE within such thirty (30) day period and LESSEE thereafter diligently prosecutes the curing of such default to completion; or

3. Whenever an involuntary petition shall be filed against LESSEE under any bankruptcy or insolvency law or under the reorganization provisions of any law or like import, or a receiver of LESSEE of or for the property of LESSEE shall be appointed without the acquiescence of LESSEE and such situation under this section 10a-3 shall continue and remain undischarged or unstayed for an aggregate period of thirty (30) days (whether or not consecutive) or shall not be remedied by LESSEE within thirty (30) days; or

4. Whenever LESSEE shall make an assignment of the property of LESSEE for the benefit of creditors, shall file a voluntary petition under any bankruptcy or insolvency law, or whenever any court of competent jurisdiction shall approve a petition filed by LESSEE under the reorganization provisions of the United States Bankruptcy Act or under the provisions of any law or like import; or

5. The abandonment of the EQUIPMENT by LESSEE or the discontinuance of the operation of such EQUIPMENT by LESSEE; or

6. The failure to notify LESSOR of any relocation within sixty (60) days; or

7. The failure of LESSEE to remove within thirty (30) days any mechanics liens on the EQUIPMENT for additional work performed on such EQUIPMENT.

b. **REMEDIES.** Upon the occurrence of an event of default under Section 10a above which is continuing and remains uncured, then LESSOR may, at its option, during the continuance of such event of default:

1. Terminate this lease by written notice to LESSEE and recover from LESSEE damages incurred by reason of such default, including the reasonable costs of recovering the EQUIPMENT and reasonable attorney's fees relating thereto, in which event LESSEE shall immediately surrender the EQUIPMENT to LESSOR, and if LESSEE fails to do so, LESSOR may take possession of the EQUIPMENT; and in that event, any rights to the EQUIPMENT that LESSEE may possess pursuant to this lease shall automatically terminate; LESSEE shall have no further right to use of the EQUIPMENT; LESSOR may, without demand or legal process, retake and retain the EQUIPMENT; all rights of LESSEE in and to the location of the installed EQUIPMENT shall be deemed automatically assigned to LESSOR; and LESSEE shall have no further rights to such location whether such rights existed during the Term hereof or arose or were to arise following termination or expiration hereof; or

2. Without terminating this lease, enter upon the location thereof and take possession of the EQUIPMENT and thereupon relet the EQUIPMENT, as LESSEE's agent, at the best price obtainable by reasonable efforts, and in such event, LESSEE shall be liable to LESSOR for any deficiency between (i) the amount of rental due hereunder plus the reasonable cost to LESSOR of recovering and reletting the EQUIPMENT, including reasonable attorney's fees, and (ii) the rental received by LESSOR from such reletting.

11. **SURRENDER.** Except as set forth herein, upon the expiration or earlier termination of this lease, LESSEE shall return the EQUIPMENT and LOCATION to LESSOR in good operating condition, normal wear and tear excepted.

12. **RIGHT OF INSPECTION.** LESSOR shall have the right at all times throughout the Term hereof to inspect the EQUIPMENT whenever and wherever the same shall be located.

13. **WARRANTIES AND CLAIMS THEREUNDER.** LESSOR makes no warranty or representation, expressed or implied, with respect to the EQUIPMENT; provided, however, that the EQUIPMENT shall be subject to any standard warranty of the manufacturers of such EQUIPMENT or components thereof. LESSOR hereby appoints LESSEE as its agent and attorney-in-fact throughout the Term hereof to assert and enforce, at LESSEE's sole expense, any claims LESSOR may have as owner of the EQUIPMENT against any vendor, manufacturer or supplier with respect thereto.

14. **ASSIGNMENT.** LESSEE shall have the right to assign or sell any of its rights hereunder. LESSOR shall have the right to sell or assign its rights hereunder, including any or all of LESSOR's right, title and interest in and to the EQUIPMENT and location and the rent reserved herein. In the event of such assignment by LESSOR, the assignee thereof shall thereupon acquire all rights and remedies possessed by or available to LESSOR. Upon receiving proper notice of any such assignment, LESSEE shall thereafter make any and all rental payments as therein directed.

15. **RIGHT OF FIRST REFUSAL.** In the event LESSOR obtains an offer from a third party for the purchase of the EQUIPMENT, then LESSOR shall thereupon provide LESSEE with written notice of the proposed sale and terms thereof. LESSEE shall thereafter have thirty (30) days from the date of its receipt of such notice in which to give written notice to LESSOR of its election to purchase the EQUIPMENT upon the same terms and conditions as the third-party offer. If LESSOR does not

receive written notice of such election from LESSEE within such thirty (30) day period, then LESSOR shall be free to sell the EQUIPMENT pursuant to such third-party offer. Should LESSEE notify LESSOR of its election to purchase, then LESSEE shall have one hundred eighty (180)days to close sale from the date of the original notice.

16. **OPTION TO SELL AGREEMENT.** Should LESSOR choose to sell the equipment to the LESSEE prior to or upon the end of the Term of the Lease, then LESSOR shall execute the Option To Sell Agreement attached hereto and by reference made a part hereof as Exhibit B. The terms and conditions of the Option to Sell Agreement shall govern the purchase by the LESSEE of the EQUIPMENT. LESSEE shall have one hundred eighty (180) days from the date of receipt of the original written notice to purchase said EQUIPMENT.

17. **PERSONAL PROPERTY:** The EQUIPMENT is and at all times throughout the Term hereof shall remain personal property, even if all or any portion of the EQUIPMENT becomes affixed or attached in any matter whatsoever to any real property.

18. **ACKNOWLEDGMENT OF DISCRETION.** LESSOR represents and warrants that (a) LESSOR is free to enter into agreements with parties other than LESSEE for the economic exploitation of the EQUIPMENT; (b) LESSOR was not required to enter into this lease as a condition to purchasing the EQUIPMENT; and (c) LESSOR has freely and voluntarily entered into this lease and acknowledges that LESSOR is not entering into or executing this lease in reliance upon any promise, representation or warranty not contained herein.

19. **NOTICES.** Any and all notices required or permitted hereunder shall be notarized in writing and sent to the intended recipient, addressed to its address set forth below, either by registered or certified mail, return receipt requested, postage prepaid, overnite delivery service, or personal delivery. Each such notarized notice shall be effective (a) if given by mail, as of three (3) business days after such notice or communication is deposited in the United States Mail; (b); if sent for overnite delivery via Federal Express or other reputable national overnite delivery service, one (1) business day after such notice or delivery is entrusted to such service, with recipient signature required; or (c) if personally delivered, when delivered at the address of the intended recipient. Any party may change the address to which notices or other communications hereunder are to be delivered by giving the other party notice in the manner set forth herein. Any notice required to be made within a stated period of time shall be considered timely mailed if deposited before midnight of the last day of the stated period.

20. **GOVERNING LAW.** This Agreement shall be governed by and construed in accordance with the laws of the State of Georgia.

21. **SPECIFIC PERFORMANCE.** Each party acknowledges and agrees that the other party would be damaged irreparably in the event any of the provisions of this Agreement are not performed in accordance with their specific terms or otherwise are breached. Accordingly, each party agrees that the other party shall be entitled to an injunction or injunctions to prevent breaches of the provisions of this Agreement and to specifically enforce this Agreement and the terms and provisions hereof in any action instituted in any court of the United States or any state thereof having jurisdiction over the parties and the matter, in addition to any other remedy to which it may be entitled, at law or in equity.

22. **DISPUTE RESOLUTION CONTRACT PROVISION.**

a. **DISPUTE.** Any dispute, controversy, or claim of whatever nature (except an interlocutory hearing for an action for a temporary restraining order, preliminary injunction, or similar

equitable relief) asserted by any party against another party arising out of, or relating to, this Agreement or the breach hereof, shall be settled by arbitration, if requested, by any party pursuant to this Section 21. The arbitration shall be conducted by one (1) arbitrator, who shall be appointed pursuant to the Commercial Arbitration Rules of the American Arbitration Association ("AAA"). The arbitration shall be held in Atlanta, Georgia, and shall be conducted in accordance with the Commercial Arbitration Rules of the AAA, except that the rules set forth in this Section 21 shall govern such arbitration to the extent that they conflict with the rules of the AAA.

b. **NOTICE.** Upon written notice by a party to another party of a request for arbitration hereunder, the parties shall use their best efforts to cause the arbitration to be conducted in an expeditious manner, with such arbitration to be completed within sixty (60) days after selection of an arbitrator. In the arbitration, Georgia law shall govern, except to the extent those laws conflict with the Commercial Arbitration Rules of the AAA and the provisions of this Section 21. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

23. **MISCELLANEOUS.** This Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject matter hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked. This Agreement shall not be modified or amended except in writing signed by both parties. This Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Agreement are inserted for convenience only and are not a part of the Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

Check one [X] Individual [ ] Partnership [ ] Corporation [ ] Self-Directed IRA [ ] Trust
[ ] Joint Tenancy with Rights of Survivorship [ ] Other:

LESSEE: ETS Payphones, Inc.
By: Charles H. Edwards

Title: CEO

Address: 561 Thornton Road, Suite K
Lithia Springs, GA 30122

Telephone Number: (770) 819-1600

Date: December 15, 1999

LESSOR: THOMASINA MARSELLA
By: X Thomasina Marsella

Title: Individual

Address: 10 PAOLINO STREET
PROVIDENCE, RI 02909

Telephone Number: (401) 421-6438

Date: 2/9/2000

Lease: 10423
Date: 01/24/00

THE EQUIPMENT
(Exhibit "A")

The equipment described herein constitutes three (3) units of operating payphone stations.

Unit 1: Location: BATES MARKET & DELI — Serial #: 32268
3145 HWY 61 EAST
LUTRELL, TN 37779
Phone #: 423-992-9753

Unit 2: Location: FRIENDLY INN #2 — Serial #: 37125
700 OLD FEDERAL HWY
HALLANDALE, FL 33009
Phone #: 954-458-9044

Unit 3: Location: LAKESIDE LAUNDRY — Serial #: 37120
016 W HALLANDALE BEACH BLVD
HALLANDALE, FL 33009
Phone #: 954-455-8912

Option To Sell AGREEMENT

(Exhibit B to Telephone Lease Agreement)

THIS AGREEMENT is made and entered into as of the 15th day of December, 1999, by and between THOMASINA MARSELLA (Individual) (hereinafter referred to as "LESSOR"), and ETS Payphones, Inc., a Georgia Corporation (hereinafter referred to as "LESSEE").

THE PARTIES HERETO ACKNOWLEDGE THAT THIS AGREEMENT INURES TO THE BENEFIT OF LESSOR, AND THAT LESSOR RETAINS SOLE AND COMPLETE DISCRETION IN DETERMINING WHETHER OR NOT TO EXERCISE THE REQUIREMENTS HEREINAFTER SET FORTH.

WITNESSETH:

WHEREAS LESSOR is the owner of three (3) unit(s) of pay telephone Equipment (the "Equipment") pursuant to that certain PURCHASE AGREEMENT dated October 26, 1999, as reflected on Invoice Number 6252 related thereto; and

WHEREAS, LESSOR and LESSEE have entered into that certain Lease Agreement (the "Lease Agreement") dated December 15, 1999 bearing Lease number 10423, pursuant to which LESSEE has LEASED the Equipment from LESSOR; and

WHEREAS, pursuant to the Lease Agreement, LESSOR is entitled to require LESSEE to purchase the Equipment prior to or upon termination of the LEASE AGREEMENT; and

WHEREAS, the parties have therefore determined that it would be appropriate and in their mutual best interests to enter into this Option to Sell Agreement in order to evidence the rights of LESSOR and the obligations of LESSEE for the sale and purchase of said Equipment; and

WHEREAS, certain terms used herein without definition shall have the meanings ascribed thereto in the Lease Agreement, and this Option to Sell Agreement is made subject to the terms and conditions of said Lease Agreement, all of which are incorporated herein and by reference made a part hereof;

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for other good and valuable consideration, the receipt and sufficiency whereof is hereby acknowledged, the parties agree as follows:

1. **Agreement to Purchase Equipment.** Subject to the terms and conditions set forth herein, LESSEE agrees to purchase the Equipment from LESSOR if LESSOR elects to sell such Equipment. If LESSOR desires that LESSEE purchase the Equipment prior to or upon expiration of the Lease Agreement, then LESSOR shall give written notice to LESSEE of such requirement. LESSEE shall have 180 days from the date of receipt of written notice to purchase equipment should LESSOR wish to sell.

2. **Purchase Price.** The price to be paid by LESSEE to LESSOR for such Equipment (the "Purchase Price") shall be Seven Thousand and no/100ths Dollars ($7,000.00) per unit. The Purchase Price shall be payable by the LESSEE's delivery of a check for the aggregate amount thereof to LESSOR at LESSOR's address set forth herein.

3. **Termination.** This Option to Sell Agreement shall terminate and be void upon the earlier of: (i) termination of the Lease Agreement; or (ii) the expiration of one hundred and twenty (120) months from execution hereof.

4. **Notices.** All notices required or permitted hereunder shall be notarized , in writing and may be delivered by hand, by nationally recognized private courier, or by United States mail. Notices delivered by mail shall be deemed given three (3) business days after being deposited in the United States mail, postage prepaid, registered or certified mail, return receipt requested. Notarized notices delivered by hand, or by nationally recognized private courier shall be deemed given on the day of receipt(if such day is a business day or, if such day is not a business day, the next succeeding business day). All notices shall be addressed as follows:

If to LESSOR: THOMASINA MARSELLA (Individual)
10 PAOLINO STREET
PROVIDENCE, RI 02909

If to LESSEE: ETS Payphones, Inc.
561 Thornton Road, Suite K
Lithia Springs, Georgia 30122

and/or to such other respective addresses as may be designated by notice given in accordance with the provisions of this Section 4.

5. **Governing Law.** This Option to Sell Agreement shall be governed by and construed in accordance with the laws of the state of Georgia .

6. **Construction.** The parties have participated jointly in the negotiation of this Option to Sell Agreement. In the event an ambiguity or question of intent or interpretation arises, this Option to Sell Agreement shall be construed as if drafted jointly by the parties and no presumption or burden of proof shall arise favoring or disfavoring any party by virtue of the authorship of any of the provisions of this Option to Sell Agreement. Any reference to any federal, state, local or foreign stature or law shall be deemed also to refer to all rules and regulations promulgated thereunder, unless the context requires otherwise.

7. **Dispute Resolution Contract Provision.**

a. **Dispute.** Any dispute, controversy, or claim of whatever nature (except an interlocutory hearing for an action for a temporary restraining order , preliminary injunction, or similar equitable relief) asserted by any party against another party arising out of, or relating to, this Option to Sell Agreement or the breach hereof, shall be settled by arbitration, if requested, by any party pursuant to this Section 7. The arbitration shall be conducted by one (1) arbitrator, who shall be appointed pursuant to the Commercial Arbitration Rules of the American Arbitration Association ("AAA"). The arbitration shall be held in Atlanta, Georgia, and shall be conducted in accordance with the Commercial Arbitration Rules of the AAA,, except that the rules set forth in this Section 7 shall govern such arbitration to the extent that they conflict with the rules of the AAA.

b. **Notice.** Upon written notice by a party to another party of a request by arbitration hereunder, the parties shall use their best efforts to cause the arbitration to be conducted in an expeditious manner, with such arbitration to be completed within sixty (60) days after selection of an arbitrator. In the arbitration, Georgia law shall govern, except to the extent those laws conflict with the Commercial Arbitration Rules

. and the provisions of this Section 7. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need. All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

8. **MISCELLANEOUS.** This Option to Sell Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Option to Sell Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Option to Sell Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Option to Sell Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject matter hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked. This Option to sell Agreement shall not be modified or amended except in writing signed by both parties. This Option to Sell Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Option to Sell Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Option to Sell Agreement are inserted for convenience only and are not a part of the Option to Sell Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

LESSEE: ETS Payphones, Inc.	**LESSOR:** THOMASINA MARSELLA
By: Charles E. Edwards	By: X Thomasina Marsella
Charles E. Edwards	
CEO	Individual

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

No. 1:00-CV-2532

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

ETS PAYPHONES, INC., AND CHARLES E. EDWARDS,
DEFENDANTS

DECLARATION OF SHELDON E. FRIEDMAN

1.

I, SHELDON E. FRIEDMAN, am over the age of eighteen and am competent in all respects to make this Declaration. This Declaration is made and presented in support of the "Opposition of Defendant Charles E. Edwards To Plaintiff's Application for Preliminary Injunction, Asset Freeze, and Other Equitable Relief," submitted in the above-referenced action.

2.

I am an attorney and named partner in the law firm of Friedman, Dever & Merlin, LLC, located at Suite 2150, Tower Place 100, 3340 Peachtree Road, NE, Atlanta, Georgia 30326-1084. I have been special counsel to ETS Payphones, Inc. ("ETS") since 1995.

3.

In September of 1995, a company related to ETS received a letter from the SEC. A copy is attached as *Exhibit 1.* Around September of 1995, Charles Edwards and I met with SEC attorney Larry Grant, out of the SEC's Atlanta office, regarding the business of ETS and Charles Edwards. As a result of research performed at the time, I presented Mr. Grant with what I believed to be the law as it related to the issue of whether ETS was engaged in the sale of a "security." Although I believe that the law at the time regarding this issue was in conflict, I recall specifically discussing with Mr. Grant my strong belief that ETS was not engaged in the sale of securities. I also provided Mr. Grant with documents provided by ETS to potential customers at the time.

4.

During the meeting, Mr. Grant suggested to Mr. Edwards and myself that ETS could avoid problems with the securities laws if it would separate the operating and marketing aspects of its business and perform one or the other. Following these suggestions, ETS restructured its operations to remove itself from the marketing aspect of its business.

5.

Following our meeting with the SEC in 1995, I did not hear from the SEC again with regard to either ETS or Mr. Edwards.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 11th day of October, 2000.

/s/ SHELDON E. FRIEDMAN
SHELDON E. FRIEDMAN

[SEAL]

United States
Securities and Exchange Commission
Atlanta District Office
3475 Lenox Road, NE
Suite 1000
Atlanta, Georgia 30326-1232

September 25, 1995

Beverly Slater
Georgia Risk Management
4290 Bells Ferry Road
Suite 106
Kennesaw, GA 30144

Re: Inter-Net, Inc.

Dear Ms. Slater:

In accordance with our telephone conversation, enclosed is SEC Form 1662 required to be given to persons requested to furnish information to the Commission.

As I state, this office is conducting an informal non-public inquiry to determine if there have been any violations of the Federal securities laws in connection with the offer and sale of "business opportunities" of Inter-Net, Inc. As discussed, I would appreciate your submitting for review the materials you are providing persons in connection with business opportunities being offered by Inter-Net, Inc. through your firm. Please

include any information concerning the leaseback and management of the telephone equipment.

The fact that we have requested such information should not be construed as a reflection upon the character or reputation of the persons or companies involved, nor as an expression of opinion on the part of the Commission or its staff that any violations have occurred.

Thank you for you assistance and cooperation. If you have any questions, please contact me at (404) 842-7660.

Sincerely,

/s/ JOSEPH L. GRANT
JOSEPH L. GRANT
District Counsel

Enclosure:

SEC Form 1662

Supreme Court, U.S.
FILED
JUN 26 2003
OFFICE OF THE CLERK

No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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Washington, D.C. 20549

QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definition of "security" under Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

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In the Supreme Court of the United States

No. 02-1196

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 300 F.3d 1281. The order of the district court (Pet. App. 16a-27a) granting the Securities and Exchange Commission's motion for a preliminary injunction is reported at 123 F. Supp. 2d 1349.

JURISDICTION

The judgment of the court of appeals was entered on August 6, 2002. A petition for rehearing was denied on November 15, 2002 (Pet. App. 28a-29a). The petition for a writ of certiorari was filed on February 13, 2003, and was granted on April 21, 2003. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The texts of 15 U.S.C. 77b(a)(1) and 78c(a)(10) are reproduced in the appendix to the petition for a writ of certiorari (Pet. App. 30a-31a).

STATEMENT

1. The definitions of "security" in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10), include not only conventional securities, such as "stock[s]" and "bond[s]," but also the more general term "investment contract." As this Court explained in *Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990), "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." Congress therefore crafted "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment." *Ibid.*

In keeping with that broad definition, the Court has held that an "investment contract" means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946). The Court has stressed that the term "investment contract" "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. The broad and flexible meaning of "investment contract" ensures that "the reach of the [securities laws] does not stop with the obvious and commonplace" but extends to "[n]ovel, uncommon, or irregular devices." *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

2. Respondent Charles E. Edwards was the founder, chairman, chief executive officer and sole owner of ETS

Payphones, Inc. (ETS). Pet. App. 1a-2a; J.A. 36, 47-48, 151, 154, 242. To raise capital to operate its payphone business, ETS and a subsidiary, under respondent's direction, sold investment packages each of which consisted of a payphone, site lease, leaseback/management agreement, and buyback agreement. Pet. App. 2a-3a, 17a; J.A. 6, 9, 128-131, 158, 208. Specifically, investors purchased payphones "complete with location" (J.A. 105) for up to $7,000 each; they then leased the phones back to ETS for five years for fixed payments of $82 per month per phone (approximately a 14% annual return) regardless of the profitability of the phone. Pet. App. 17a-18a; J.A. 11, 128-129. As part of the lease agreement, ETS promised to refund the full purchase price of each phone package at the end of the lease term or within 180 days of the investor's request. Pet. App. 17a; J.A. 11, 104, 129. There was up to a three-month lag between the time an investor paid the purchase price for a payphone package and the time he was assigned a specific payphone and location by ETS. J.A. 10, 190-191, 194.[1]

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[1] The facts set forth in this brief are taken from the complaint that the Securities and Exchange Commission filed against Edwards and ETS, the factual findings made by the district court in granting a preliminary injunction, and the record submitted in support of the motion for a preliminary injunction. As described below, the court of appeals not only reversed the preliminary injunction but also ordered the dismissal of the complaint for lack of subject matter jurisdiction. This Court therefore must accept the allegations in the complaint as true. See *Saudi Arabia* v. *Nelson*, 507 U.S. 349, 351, 354 (1993). If the dismissal is instead regarded as based upon failure to state a claim, then the allegations must likewise be accepted as true. See *SEC* v. *Zandford*, 535 U.S. 813, 818 (2002); *Steel Co.* v. *Citizens for a Better Env't*, 523 U.S. 83, 89 (1998) ("absence of a valid (as opposed to arguable) cause of action does not implicate subject-matter jurisdiction").

Investors did not receive physical delivery of their phones, did not see the locations where the phones were installed (which were often far from where investors lived), and did not participate in operating the business. ETS found and chose the locations for the phones, installed them, connected them to telephone lines, arranged for long distance service, collected coin revenues, and maintained and repaired the phones. Pet. App. 17a, 22a; J.A. 11, 78-79, 91, 116, 119, 224, 225-226, 239-240, 253. Many of the investors were elderly; virtually all had no experience in managing payphones and were dependent upon the experience and resources of ETS to obtain the promised return on their investment. J.A. 10, 78-79, 83, 239-240.

ETS marketed its investment packages over the internet and through a network of independent distributors. Pet. App. 17a; J.A. 9-10, 165-173. Promotional brochures and materials on the web sites portrayed ETS and its management as experienced and successful in the telecommunications industry and "noted the 'profitable' opportunities for investors." Pet. App. 17a-18a; see J.A. 94, 100-102, 105, 113-120, 223, 227-228, 231, 234. The marketing materials touted "the 'profitability' of payphones and encouraged investors to 'watch the profits add up.'" Pet. App. 17a-18a; see J.A. 12, 13, 100-102, 114, 117, 118, 120, 124, 228. The ETS program was described as "virtually recession-proof," providing a "steady, immediate cash flow," easily liquidated, and suitable for retirement accounts. J.A. 10, 98, 101, 105, 115, 227, 235. As a result of that marketing, ETS took in approximately $300 million from more than 10,000 investors across the country. See Pet. App. 3a, 23a; J.A. 6.

Although the sales literature and web sites presented ETS as a profitable company, ETS was never profitable. Pet. App. 18a, 24a; J.A. 38-40, 73-77, 219-220.

Because revenue from payphone operations fell short of the amount needed to meet rental payments to investors, ETS used funds from new investors to pay existing investors. Pet. App. 18a, 24a; J.A. 14, 40, 49, 76. ETS had an operating loss of more than $42 million in 1999 and more than $33 million for the first six months of 2000. J.A. 38, 73. In September 2000, ETS and several of its subsidiaries filed for bankruptcy protection. Pet. App. 19a.

Respondent was aware of ETS's poor financial condition, including the fact that the company was dependent on funds from new investors to sustain its operations. Pet. App. 19a, 25a; J.A. 49, 189, 220-221. Respondent nonetheless failed to disclose to investors ETS's true financial situation or that ETS would be unable to honor its commitment to repurchase investors' phones if a significant number of investors exercised their option to have ETS buy back their phones. Pet. App. 18a, 24a; J.A. 14, 79, 192-193, 240. Indeed, "[d]espite [his] knowledge, [respondent] marketed the program as a profitable enterprise 'ringing with opportunity.'" Pet. App. 25a. In a communication as late as July 2000, only two months before ETS's bankruptcy filing, respondent reassured investors of ETS's financial stability and represented that the company had made a profit of nearly $9 million in 1999. J.A. 230.

Notwithstanding ETS's consistent losses, respondent personally profited. Pet. App. 18a. Respondent drained approximately $18 million from the company in direct compensation, management fees, and interest-free loans to other companies he controlled. *Ibid.*; *id.* at 27a; J.A. 41, 51-53, 54-56, 209-216.

3. In September 2000, the Securities and Exchange Commission (SEC or Commission) brought this civil law enforcement action against respondent and ETS in

the United States District Court for the Northern District of Georgia. The SEC alleged that respondent and ETS, in carrying out their payphone investment scheme, violated the registration requirements of Section 5(a) and (c) of the Securities Act, 15 U.S.C. 77e(a) and (c), and the antifraud provisions of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Compl. 9-12.[2] The Commission sought a permanent injunction against future violations of the registration and antifraud provisions, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties. *Id.* at 12-16.[3]

The Commission moved at the outset of the case for preliminary relief. Following an evidentiary hearing, the district court found that the SEC had made a prima facie showing that respondent had committed the al-

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[2] The registration provisions of the Securities Act require the filing of a registration statement with the SEC and the delivery to investors of a prospectus containing various items of information, including the company's financial statements. See 15 U.S.C. 77f, 77g(a), 77j; 15 U.S.C. 77aa, Sched. A, Items 25, 26. Section 17(a) of the Securities Act proscribes fraudulent conduct in the offer or sale of securities. 15 U.S.C. 77q(a). Section 10(b) of the Exchange Act and Rule 10b-5 prohibit fraud in connection with the purchase or sale of any security. 15 U.S.C. 78j(b); 17 C.F.R. 240.10b-5.

[3] On December 20, 2002, the United States Attorney for the Northern District of Georgia filed a complaint for forfeiture, pursuant to 18 U.S.C. 981(a)(1)(C), against the funds in certain bank accounts and certain real property alleged to represent the proceeds of wire fraud, in violation of 18 U.S.C. 1343, committed by respondent in the operation of his payphone business. See *United States* v. *Any and All Funds Maintained in the Name of Twinleaf, Inc.*, No. 1:02-CV-3434 (N.D. Ga.). The assets identified in the forfeiture complaint were seized on or about January 3, 2003, and are currently under government control.

leged violations, and the court granted the Commission's request for preliminary relief against him. Pet. App. 16a-27a.[4]

The district court found that the payphone sale/leaseback/buyback arrangement was an "investment contract" under the federal securities laws. Pet. App. 17a-23a. The court applied the test for an investment contract set forth in *Howey*. *Id.* at 19a (noting that, under *Howey*, 328 U.S. at 298-299, "[a]n investment contract is 'a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party'"). The court found that those who purchased the payphone interests had made "an investment of money." *Ibid.* The court also found a "common enterprise," because recovery of the investments "depend[ed] upon the financial viability of [ETS] and [its] ability to generate a profit." *Id.* at 21a. Finally, the court found that the investors expected profits from ETS's efforts rather than their own, because they had relinquished "all responsibility for the payphones" to respondent and ETS, who "monitored, managed, and maintained" the phones. *Id.* at 22a.

After determining that the payphone arrangement was an investment contract, the district court concluded that the SEC had established a prima facie case that respondent had violated the registration requirements of the Securities Act by selling "unregistered securities to thousands of people in thirty-eight states." Pet. App. 23a. The court also found that the SEC had established a prima facie case that respondent had com-

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[4] ETS itself, without admitting or denying the allegations in the complaint, consented to a preliminary injunction. Pet. App. 16a. ETS later consented to a permanent injunction. J.A. 5.

mitted fraud in connection with the sale of securities because "investors were led to believe that both ETS and its payphone program generated a profit" while, in fact, "ETS had failed to make a profit," "was losing money on its payphone program," and "depended on funds from new investors in order to sustain operations." *Id.* at 24a. Concluding that the SEC was likely to succeed on the merits, the court entered a preliminary injunction that prohibited respondent from engaging in future violations of the registration and antifraud provisions of the securities laws and that froze respondent's assets to the extent they were not subject to the bankruptcy proceedings involving ETS and its subsidiaries. *Id.* at 26a-27a.

4. Respondent appealed. In a per curiam opinion, the United States Court of Appeals for the Eleventh Circuit not only reversed the district court's grant of the preliminary injunction, but also ordered dismissal of the SEC's complaint for lack of subject matter jurisdiction under the federal securities laws. Pet. App. 1a-15a. The court of appeals held that the payphone sale/leaseback/buyback scheme did not involve an "investment contract." *Id.* at 4a-8a.

The court of appeals acknowledged that the scheme involved "an investment of money" (Pet. App. 5a) and that investors purchased the payphone packages "for the purpose of earning a return on the purchase price" (*id.* at 6a). The court concluded, however, that the SEC could not show "that investors who contracted with ETS expected profits to be derived solely through the efforts of others." *Ibid.*

The court of appeals understood the decision in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975), to have limited the scope of "profits" under the description of investment contract in *Howey*

to "capital appreciation" or "a participation in earnings" of the enterprise. Pet. App. 6a. The court of appeals held that the monthly payments that ETS investors received were not a participation in ETS's earnings because they were "fixed" amounts, rather than amounts that varied according to ETS's earnings. *Id.* at 7a.

The court of appeals also held that, even if the monthly payments could be considered profits, they were not "derived solely from the efforts of others." Pet. App. 7a. The court reasoned that "the determining factor is the fact that the investors were entitled to their lease payments under their contracts with ETS." *Id.* at 8a. Because their returns were thus "contractually guaranteed," the court held, "those returns were not derived from the efforts of [respondent] or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract." *Ibid.*

Because the court of appeals concluded that investors in the ETS payphone scheme did not expect profits derived from the efforts of others, the court deemed it unnecessary to determine whether there was a "common enterprise" as described in *Howey*. Pet. App. 5a-6a. Judge Lay, however, filed a concurring opinion addressing that issue. *Id.* at 9a-15a.

The court of appeals subsequently denied the SEC's petition for rehearing and rehearing en banc. Pet. App. 28a-29a.

SUMMARY OF ARGUMENT

The payphone packages sold by respondent were "investment contracts" and therefore "securities" for purposes of the Securities Act and the Exchange Act. Those investments are not excluded from that status because they offered a fixed return or because that return was "contractually guaranteed," *i.e.*, specified as

an entitlement in the investment agreements. That conclusion follows from the definition of "security" in the federal securities laws and the purposes underlying those laws, and it is consistent with the longstanding interpretation of the SEC. The court of appeals erred in departing from the SEC's interpretation; and the court's holding, if endorsed by this Court, would create a serious loophole in the securities laws.

A. The securities laws define "security" in the broadest possible terms to achieve Congress's purpose of regulating all investments, regardless of the form in which they are made or the name by which they are called. To ensure the comprehensiveness of the definition of security, Congress included in the definition not only standardized instruments, such as stocks and bonds, but also a general descriptive term that is a catch-all for unconventional investment arrangements. That term, "investment contract," is broadly phrased and easily accommodates an investment offering a fixed or contractually guaranteed return. Moreover, Congress adopted the term "investment contract" from the state Blue Sky Laws, and the broad meaning of "investment contract" under those laws encompassed instruments with fixed and contractually guaranteed returns.

In addition, the role of "investment contract" as a catch-all in the definition of "security" requires that the term include fixed- and guaranteed-return investments. Many of the conventional instruments specifically identified in the definition as securities traditionally yield a fixed return, *e.g.*, bond and debenture, and that fixed return is typically promised in the instrument itself. The scope of the catch-all should be interpreted in light of both the specifically listed securities (such as bonds and debentures) and the catch-all's function—to

ensure coverage of instruments that embody the essential attributes of a security, whether equity or debt.

Inclusion of investments with fixed or contractually promised returns is necessary to achieve the goals of the securities laws. Those who purchase fixed-return investments need the protections of those laws just as much as those who purchase variable-return investments. For that reason, Congress imposed disclosure and antifraud requirements on transactions in *all* securities, whether equity or debt. Indeed, in the SEC's experience, the perpetrators of fraudulent schemes frequently promise fixed or guaranteed returns, and those returns may be particularly attractive to the elderly and unsophisticated investors who are most vulnerable to fraud.

B. The conclusion that the term "investment contract" includes arrangements involving fixed or contractually guaranteed returns is also supported by this Court's cases. In *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 299 (1946), the Court articulated a "flexible" definition of "investment contract" that the Court stressed was "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." The Court equated that definition—a "scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"—with the definition under the Blue Sky Laws, which encompassed investments offering fixed and contractually promised returns. *Id.* at 298-299.

The Court has taken a similarly broad approach to the scope of "investment contract" in its other cases, such as *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and *SEC* v. *United Benefit Life Insurance Co.*,

387 U.S. 202 (1967). In those cases, the Court emphasized that whether a financial arrangement is an investment contract depends heavily on how it was promoted. See *Joiner*, 320 U.S. at 352-353; *United Benefit*, 387 U.S. at 211. The pitch of the promotional materials here—that investors could expect "profits" from a profitable company in a profitable industry without expending any effort themselves—fits easily within the definition of investment contract. And *United Benefit* more specifically reinforces the conclusion that an investment contract may offer a fixed return promised in the contract, because the annuity in that case, which the Court held to be an investment contract, offered a guaranteed fixed-dollar amount as one alternative return. See 387 U.S. at 205.

C. The SEC has long interpreted "investment contract" to include investment agreements offering fixed and guaranteed returns. That interpretation, which dates back to shortly after the federal securities laws were enacted, is embodied in formal adjudications by the SEC. See *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940); *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), *available in* 1969 WL 95359, order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,813, at 90,056 (D.C. Cir. Sept. 25, 1970); *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), *available in* 1982 WL 522493. The SEC's reasonable interpretation of the securities laws is entitled to deference. See *SEC* v. *Zandford*, 535 U.S. 813, 819-820 (2002).

D. The court of appeals' erroneous holding in this case, if affirmed by this Court, would open a serious loophole in the securities laws. Unscrupulous promoters who seek to finance their business enterprises with the money of others could circumvent the securities laws by selling investments offering fixed or contractually guaranteed returns even though those investments function economically like other investments sold to raise capital. That result would frustrate Congress's goals of regulating all instruments sold as investments and thereby providing comprehensive protection for investors.

ARGUMENT

RESPONDENT'S AGREEMENTS WITH INVESTORS WERE "INVESTMENT CONTRACTS" AND THUS "SECURITIES," EVEN THOUGH INVESTORS WERE CONTRACTUALLY ENTITLED TO A FIXED RETURN

To raise capital to operate a payphone business, respondent sold members of the general public across the country packages consisting of a payphone, a location for the phone, and an agreement to lease the phone, to manage it, and to repurchase it at the end of the lease or at the investor's option. Respondent promoted the packages as passive investments through which investors could obtain "profits," and investors entrusted their money to respondent for that purpose. See pp. 3-4, *supra*.

The agreements between respondent and the public investors who financed his business are precisely the kind of arrangements that Congress sought to regulate as securities under the Securities Act of 1933, 15 U.S.C. 77a *et seq.*, and the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.* Those arrangements fall squarely within the term "investment contract," a category included in the definition of "security" in both Acts. 15 U.S.C. 77b(a)(1), 78c(a)(10). The general term "investment contract" was included in the definition to ensure that the Acts' reach would extend to even the most unusual arrangements, and thereby to advance Congress's

"intent to regulate the entire body of instruments sold as investments." *Reves* v. *Ernst & Young*, 494 U.S. 56, 64 (1990). See *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 299 (1946); *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

Given the broad statutory language and congressional purpose, the SEC has always interpreted the term "investment contract" to include an investment offering a fixed return or a return that is specified or promised as an entitlement in a contract (in the terminology of the court of appeals, "contractually guaranteed").[5] See, *e.g.*, *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940). That longstanding interpretation is embodied not just in the SEC's enforcement actions and interpretive guidance, but also in formal SEC adjudications, and is therefore entitled to deference. See *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), *available in* 1969 WL 95359, order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,813, at 90,056 (D.C. Cir. Sept. 25, 1970); *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), *available in* 1982 WL 522493. Indeed, the SEC's interpretation follows from the text

[5] A true guaranty is a promise by a third party to pay the debt or otherwise perform the obligation of the principal promisor in the event of nonpayment or other nonperformance by the principal promisor. See *Black's Law Dictionary* 634 (5th ed. 1979). No such guaranty was present here. Rather, the court of appeals used the term "contractually guaranteed" more loosely, as a shorthand description of the fact that "investors were entitled to their lease payments under their contracts with ETS." Pet. App. 8a. Thus, the court apparently used the term merely to indicate that the amount or rate of return was specified or expressly promised in the contracts. Except where otherwise indicated, this brief uses the term in that sense.

of the securities laws, promotes their underlying purposes, and has substantial support in precedent.

A. The Statutory Text And Purposes Demonstrate That An "Investment Contract" Includes An Arrangement With A Fixed Or Contractually Guaranteed Return

1. As this Court has repeatedly stressed, the federal securities laws define "security" in the broadest terms. See *Reves*, 494 U.S. at 60-61; *Marine Bank* v. *Weaver*, 455 U.S. 551, 555 (1982); *United Hous. Found., Inc.* v. *Forman*, 421 U.S. 837, 847-848 (1975); *Tcherepnin* v. *Knight*, 389 U.S. 332, 338 (1967). The definitions in the Securities Act and the Exchange Act each contain a long and sweeping list of instruments and arrangements that are included in the expansive concept of a "security." Those items include, among other things, "any note, stock, treasury stock, security future, bond, debenture" and any "collateral-trust certificate, preorganization certificate, or subscription, transferable share, investment contract," or any "instrument commonly known as a 'security.'" 15 U.S.C. 77b(a)(1), 78c(a)(10).[6]

Those expansive definitions reflect that "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61. Congress determined that the best way to achieve the goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within

[6] The full text of each definition is reproduced in the appendix to the petition. Pet. App. 30a-31a. Although the two definitions contain some differences in language, the Court has treated them as essentially identical in meaning. See *Reves*, 494 U.S. at 61 n.1.

the ordinary concept of a security.'" *Forman*, 421 U.S. at 847-848 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)).

In order to craft "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment," *Reves*, 494 U.S. at 61, Congress included in the definition not just "standardized" instruments, such as stocks and bonds, but also arrangements "of more variable character" that it "designated by more descriptive terms," such as "investment contracts." *Joiner*, 320 U.S. at 351. Congress included those "general descriptive designations" to ensure the comprehensiveness of the Acts' coverage, which "does not stop with the obvious and commonplace" but includes "[n]ovel, uncommon, or irregular devices" that are offered as investments. *Ibid.* See also *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 690 n.4 (1985) (investment contract cases have "involved unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities"); *Howey*, 328 U.S. at 299 (emphasizing flexibility and adaptability of "investment contract" concept).[7]

[7] The definitions of "security" include another broad descriptive category, which is referred to in the Securities Act definition as "any interest or instrument commonly known as a 'security,'" 15 U.S.C. 77b(a)(1), and in the Exchange Act definition as "any instrument commonly known as a 'security,'" 15 U.S.C. 78c(a)(10). The Court has generally treated that catch-all category as interchangeable with the "investment contract" category, see *Forman*, 421 U.S. at 852; *Joiner*, 320 U.S. at 351, and has indicated that the test for identifying whether an interest or instrument falls within either category is substantially the same, see *Landreth*, 471 U.S. at 691-692 n.5; *Forman*, 421 U.S. at 852. To the extent that there is a difference between the two categories, "any interest or instrument commonly known as a 'security'" may be narrower because of its reference to an arrangement "commonly known" as a "security," while "investment contract" encompasses an arrangement that, although it may not be "commonly known" at all, "embodies the essential attributes" of "a security." *Forman*, 421 U.S. at 852.

The term "investment contract" is broadly phrased and easily accommodates an investment offering a fixed return or a return that is promised by the terms of the parties' agreement. The first word in the quoted term, "investment," means the "investing of money or capital in some species of property for income or profit," and "invest" means "to lay out (money or capital) in business with the view of obtaining an income or profit." *Webster's New International Dictionary* 1306 (2d ed. 1934) (*Webster's New Int'l*); accord *Webster's Third New International Dictionary* 1190 (1993) (*Webster's Third*). The terms "income" and "profit" in turn connote any financial return, whether fixed or variable, guaranteed or not guaranteed. Thus, "income" includes any "gain or recurrent benefit," and "profit" encompasses "any benefit or advantage accruing from the management, use, or sale of property, or from the carrying on of any process of production, or from the conduct of business." See *Webster's New Int'l* at 1258, 1976; *Webster's Third* at 1143, 1811.

The second word in the quoted term, "contract," means "[a]n agreement between two or more persons to do or forbear something." *Webster's New Int'l* at 578; accord *Webster's Third* at 494. Thus, the very term "investment *contract*" makes clear that instruments of that name include those in which a return—whether labeled income or profit—is promised in a contract.[8]

[8] Other leading dictionaries, both when the securities laws were enacted and today, confirm that the term "investment contract" includes an agreement that promises a specified or fixed return. See, *e.g.*, 5 *The Oxford English Dictionary* 458 (1933)

Further, as this Court noted in *Howey*, the term "investment contract" had a well-established meaning under cases construing the state Blue Sky Laws that predated the federal securities laws. 328 U.S. at 298. The Blue Sky Law cases had construed investment contract "broadly" so as "to afford the investing public a full measure of protection." *Ibid.* As a result, the term had come to mean "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'" *Ibid.* (quoting *State* v. *Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920)). That definition, which includes both "income" and "profit," is clearly expansive enough to include an investment having a fixed or contractually guaranteed return.

Indeed, two of the state cases cited by this Court in *Howey* to illustrate the meaning of "investment contract" involved fixed or contractually guaranteed returns. See *People* v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) (return of $7500 on investment of $5000); *Stevens* v. *Liberty Packing Corp.*, 161 A. 193, 195 (N.J. Ch. 1932) ("guaranteed" return amounting to $56 per year on investment of $175). Congress presumably intended that the term "investment contract" in the federal securities laws would, consistent with state cases construing the same language, likewise be interpreted to include arrangements involving fixed and contractually specified returns. See *Howey*, 328 U.S. at

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(*Oxford Dictionary*) ("investment"); *id.* at 162 ("income"); 8 *Oxford Dictionary* 1432 ("profit"); 2 *Oxford Dictionary* 912 ("contract"); *Black's Law Dictionary* 1006 (3d ed. 1933) ("invest"); *id.* at 944 ("income"); *id.* at 1440 ("profit"); *id.* at 421 ("contract"); *The Random House Dictionary of the English Language* 1004 (1987) ("invest" and "investment"); *id.* at 967 ("income"); *id.* at 1545 ("profit"); *id.* at 441 ("contract").

298 (concluding that Congress adopted the definition of "investment contract" reflected in the state cases); *Evans* v. *United States*, 504 U.S. 255, 260 n. 3 (1992) ("if a word is obviously transplanted from another legal source, whether the common law or other legislation, it brings the old soil with it") (quoting Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum. L. Rev. 527, 537 (1947)).

2. The role of the term "investment contract" in the statutory definitions of "security" confirms that the term includes an agreement providing for a fixed or guaranteed return. As the Court's discussion in *Joiner*, *Howey*, and other cases illustrates, Congress included the term "investment contract" as a catch-all for unusual investments that cannot be categorized as one of the standardized instruments that are also identified in the definitions. See pp. 15-16, *supra*; *Golden* v. *Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982). Several of the conventional securities enumerated in the definitions of security are debt securities that traditionally yield a fixed return, *e.g.*, "bond" and "debenture," 15 U.S.C. 77b(a)(1), 78c(a)(10), and that return is typically promised ("guaranteed") in the instrument itself. Moreover, the definition of security in the Securities Act expressly includes a "guarantee of" any of the other listed items. 15 U.S.C. 77b(a)(1). Because the specific securities listed in the definitions of security include investments having returns that are fixed and contractually guaranteed, it makes sense that the catch-all term "investment contract" should also include such investments. See *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 575 (1995) (relying on the principle that "a word is known by the company it keeps" and noting that the Court has applied that principle in interpreting the definition of "security" in the Exchange Act).

Consistent with the term's role as a catch-all, the Court has noted that the definition of "investment contract" "embodies the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852 (citing *Joiner*, *Tcherepnin*, and *Howey*). Those essential attributes include debt as well as equity participation, and returns that are contractually specified as well as those that are not. See *Webster's New Int'l* at 2263 (defining "security" as "[a]n evidence of *debt* or of property, as a *bond*, stock certificate, or other instrument") (emphasis added); *Webster's Third* at 2053-2054 (defining "security" as "a written obligation, evidence, or document of ownership or *creditorship* (as a stock, *bond*, *note*, *debenture*, or certificate) giving the holder the right to demand and receive property not in his possession) (emphasis added). The "fundamental essence of a 'security'" is "its character as an 'investment.'" *Reves*, 494 U.S. at 68-69. For that reason, an instrument may be an investment contract if it has the essential properties of *either* "a debt or equity security," *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994), and investment contracts may offer either fixed or contractually guaranteed returns.

Inclusion of investments with fixed or contractually promised returns in the catch-all category of "investment contract" is necessary to achieve the securities laws' goals of ensuring honest securities markets and protecting investors from fraud. Purchasers of fixed-return investments need the protections provided by the securities laws just as much as the purchasers of variable return investments, because both categories of investors are dependent on the efforts of others to manage successfully the enterprise in which they invest. Congress recognized as much by requiring that

issuers making public offerings of *any* securities, debt or equity, disclose information about the company's financial condition, including its assets and liabilities, and its earnings, income, and expenses. See 15 U.S.C. 77g(a); 15 U.S.C. 77aa, Sched. A, Items 25, 26. Likewise, the fraud prohibitions in the Acts extend to all securities, not only equities. Indeed, in the Commission's experience, those who perpetrate fraudulent investment schemes frequently promise fixed or guaranteed returns (see pp. 28-34, 41-42 & note 14, *infra*), and such promises may be particularly attractive to the elderly or unsophisticated investors who are most likely to fall victim to fraud. Thus, coverage of investments offering fixed or contractually guaranteed returns is critical to Congress's goal of providing comprehensive protection to investors by "regulat[ing] *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61.

B. Precedent Confirms That An "Investment Contract" May Offer A Fixed Or Contractually Guaranteed Return

1. The conclusion that an "investment contract" may offer a fixed or contractually guaranteed return is also supported by this Court's cases. The Court has consistently applied a broad and flexible definition of "investment contract." As noted above, in *Howey*, the Court concluded that Congress adopted the expansive definition of "investment contract" that had been used by state courts interpreting Blue Sky Laws. The Court paraphrased that definition as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party" (*Howey*, 328 U.S. at 298-299) and, later in the opinion,

as a "scheme [that] involves an investment of money in a common enterprise with profits to come solely from the efforts of others" (*id.* at 301). The Court noted that the definition is "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. The Court stressed that, in applying the definition, the emphasis is on "economic reality" and the substance of the transaction rather than its form. *Id.* at 298. The Court further cautioned that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301.

Applying that "flexible" approach, the Court in *Howey* concluded that the investments at issue there—fee-simple interests in citrus groves packaged with service contracts to cultivate the land, sell the fruit, and remit any profit to the investors—were investment contracts. 328 U.S. at 299-300. The Court cited a variety of cases (*id.* at 299 n.5), including a formal adjudication by the Commission, in which "transactions which, in form, appear to involve nothing more than the sale of real estate, chattels, or services, have been held to be investment contracts where, in substance, they involve the laying out of money by the investor on the assumption and expectation that the investment will return a profit without any active effort on his part." *In re Natural Res. Corp.*, 8 S.E.C. 635, 637 (1941). The Court explained that it is "immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise," *Howey*, 328 U.S. at 299, even if the "tangible interest which is sold has intrinsic value independent of the success of the enterprise as a

whole" (*id.* at 301). See also *Joiner*, 320 U.S. at 352-353 n.10.[9]

In concluding that the citrus grove scheme involved an investment contract, the Court in *Howey* relied on the fact that investors did not expect to use the land themselves, but instead were "attracted solely by the prospects of a return on their investment." 328 U.S. at 300. The Court was not concerned with whether the anticipated return was fixed or variable, contractually promised or unspecified. On the contrary, the Court stated that, in determining whether an investment contract is involved, "it is immaterial whether the enterprise is speculative or non-speculative." *Id.* at 301.

Although the interpretation that the Court articulated used the term "profit," the Court did not, by using that term, signal that investment contracts must offer variable or unspecified returns. As described above, the ordinary meaning of "profit" encompasses any kind of financial return, including one that is fixed or contractually guaranteed. See p. 17, *supra*. Moreover, the interpretation of investment contract that the Court

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[9] In the half century since *Howey*, the courts of appeals have continued to find such schemes to be investment contracts. See *Blackwell* v. *Bentsen*, 203 F.2d 690 (5th Cir. 1953) (citrus groves), cert. dismissed, 347 U.S. 925 (1954); *Continental Mktg. Corp.* v. *SEC*, 387 F.2d 466 (10th Cir. 1967) (beavers), cert. denied, 391 U.S. 905 (1968); *Kemmerer* v. *Weaver*, 445 F.2d 76 (7th Cir. 1971) (beavers); *Glen-Arden Commodities, Inc.* v. *Costantino*, 493 F.2d 1027 (2d Cir. 1974) (whiskey); *Miller* v. *Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (chinchillas); *Smith* v. *Gross*, 604 F.2d 639 (9th Cir. 1979) (earthworms); *United States* v. *Jones*, 712 F.2d 1316, 1321-1322 (9th Cir.) (truck trailers), cert. denied, 464 U.S. 986 (1983); *Albanese* v. *Florida Nat'l Bank*, 823 F.2d 408 (11th Cir. 1987) (ice machines); *Long* v. *Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989) (cattle); *Bailey* v. *J.W.K. Prop., Inc.*, 904 F.2d 918 (4th Cir. 1990) (cow embryos).

quoted from a leading Blue Sky Law case used the even broader phrase "income or profit." See *Howey*, 328 U.S. at 298 (quoting *Gopher Tire & Rubber Co.*, 177 N.W. at 938). And the Court cited with approval not only the two state cases involving fixed or guaranteed returns described above, but also an SEC injunctive action in which the investment contract promised a fixed return. See *Howey*, 328 U.S. at 299 n.5 (citing *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232, 237-238 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940)).[10]

Respondent's payphone packages fit squarely within *Howey*'s understanding of an investment contract. Like the citrus grove investments in *Howey*, the payphone investments were nominally structured as a sale of property coupled with a leaseback and management agreement. But, also like the *Howey* investments, in substance, they involved the laying out of money by investors in the expectation of a financial return without any active effort on their part. Just as the investors in *Howey* generally knew nothing about running a citrus grove, lived far from the groves they purchased, and had no intention of cultivating the groves themselves, the investors in respondent's payphone packages generally knew nothing about operating payphones, lived far from the phones that respondent assigned them, and had no intention of operating the phones themselves. Compare *Howey*, 328 U.S. at 299, with p. 4, *supra*. They were passive investors, "attracted solely by the prospects of a return on their

[10] The fact that the ordinary meaning of "profit" encompasses a fixed return is reinforced by this Court's statement in *Reves* that, in the context of notes, the Court uses the term "profit" to mean "a valuable return on an investment," including a return "in the form of interest." 494 U.S. at 68 & n.4. See pp. 36-37, *infra*.

investment," and their agreements with respondent were therefore investment contracts. *Howey*, 328 U.S. at 299-300.

2. The conclusion that respondent's agreements with investors were investment contracts is also supported by this Court's other cases. In *Joiner*, the Court held that assignments of oil leases, sold in a nationwide campaign that promoted them as investments and "assured [potential investors] that the Joiner Company was engaged in and would complete the drilling of a test well * * * to test the oil-producing possibilities of the offered leaseholds," were securities in the form of investment contracts. 320 U.S. at 346. The Court reasoned that whether an investment contract is involved turns on "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-353. "In the enforcement of an act such as this," the Court stressed, "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." *Id.* at 353.

The Court took the same approach in *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967). In that case, the Court reiterated that, in determining whether financial arrangements are investment contracts, promoters should be held accountable for their representations to prospective investors. *Id.* at 211. Based on that principle, the Court held that investments in certain annuity products were investment contracts because the promotional materials stressed "the possibility of investment return" and "the prospect of 'growth' through sound investment management." *Id.* at 211 & n.15.

Viewed in light of the promoter's representations, as in *Joiner* and *United Benefit*, the payphone packages

here are plainly investment contracts. Respondent consistently marketed the arrangement as an investment opportunity that would provide "profits." See Pet. App. 17a-18a; J.A. 100-102, 114-115, 117-119, 124, 223, 227. The lure that respondent's promotional materials held out to prospective investors—the expectation of a return on their money from a profitable company in a profitable industry, with no effort expended by the investors themselves—readily fits within *Howey*'s description of investment contract.

United Benefit also indicates that an investment contract may offer a fixed return the amount of which is promised in the investment contract. The annuity product in *United Benefit* provided two alternative returns. Under one alternative, the purchaser was entitled to "his proportionate share" of the total amount that had been generated with the initial investments. 387 U.S. at 205. Under the other alternative, the purchaser could select a "cash value measured by a percentage of his net premiums, which gradually increase[d] from 50% of that sum in the first year to 100% after 10 years." *Ibid.* The latter alternative return was thus a fixed amount (albeit one that increased with each year that the investor participated in the annuity), and the investor was guaranteed that fixed amount by the contract. Indeed, the Court later referred to the alternative return as a "guarantee." *Id.* at 211.

Although the Court in *United Benefit* did not address an argument that the guaranteed fixed return prevented the annuity from being an investment contract, the Court was fully aware of that feature of the annuity. Indeed, the Court expressly rejected the argument that the guaranteed return made the annuity an "insurance" product, which is exempt from coverage

under the Securities Act. 387 U.S. at 210-211; see 15 U.S.C. 77c(a)(8). It therefore is significant that the Court made no mention of any possibility that the guaranteed return would disqualify the investment from being an investment contract. Given the prominence of the guaranteed return in the Court's analysis, it seems clear that the Court did not believe that the nature of that return disqualified the annuity from being an investment contract.

3. The Court has consistently followed the approach illustrated by *Howey*, *Joiner*, and *United Benefit* in other cases involving investment contracts. For example, the Court has repeatedly emphasized the breadth and flexibility of the definition. See *Marine Bank*, 455 U.S. at 555-556; *Forman*, 421 U.S. at 847-848; *Tcherepnin*, 389 U.S. at 338. The Court has also frequently stressed the importance of economic reality and substance rather than form. See *Forman*, 421 U.S. at 848; *Tcherepnin*, 389 U.S. at 336; *Marine Bank*, 455 U.S. at 560 n.11. And the Court has repeatedly looked to the promoter's representations in characterizing the instrument. *Marine Bank*, 455 U.S. at 556; *Forman*, 421 U.S. at 850-851; see *Reves*, 494 U.S. at 69-70 (relying on fact that advertisements for notes characterized them as "investments" in holding that the notes were securities); *Landreth*, 471 U.S. at 686 (relying on purchaser's expectations in concluding that an instrument that is called stock and bears the usual characteristics of stock is a security). All of those considerations reinforce the conclusion that respondent's payphone packages were investment contracts notwithstanding that investors were entitled by contract to a fixed return.

4. In keeping with this Court's cases, several courts of appeals have specifically recognized that investments offering fixed and contractually guaranteed returns

come within the term "investment contract." In *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), the Third Circuit expressly rejected the argument that the promise of a fixed return precludes an investment scheme from qualifying as an investment contract. Purchasers of Infinity's "property transfer contracts" transferred money to a trust to invest at the trustees' discretion. *Id.* at 184. As in the present case, participants were by "contract[]" "guaranteed," *id.* at 187, a high, fixed rate of return and repayment upon demand, *id.* at 184-85 & n.2. Notwithstanding the fixed and contractually guaranteed return, the Third Circuit held that the property transfer contracts "clearly constitute securities." 212 F.3d at 191. The court explained that

> the definition of security does not turn on whether the investor receives a variable or fixed rate of return. * * * The mere fact that the expected rate of return is not speculative does not, by itself, establish that the property transfer contracts here are not "investment contracts" within the meaning of [the] federal securities laws.

Id. at 189. The court concluded: "We will not embroider a loophole into the fabric of the securities laws by limiting the definition of 'securities' in a manner that unduly circumscribes the protection Congress intended to extend to investors." *Id.* at 191.

Similarly, in *United States* v. *Carman*, 577 F.2d 556 (1978), the Ninth Circuit held that an investment with a fixed return and a conditional third-party guaranty was an investment contract. The defendant in *Carman* sold a different asset than respondent—a federally-insured student promissory note rather than a payphone—but with a similar addition of a service contract and a

repurchase agreement. *Id.* at 560. The *Carman* court held that "[t]he combination created an integrated investment package which must be viewed in its entirety in determining whether it is within or without the Act." *Id.* at 564 (internal quotation marks and citation omitted).

The *Carman* court rejected the defendant's argument that the package could not be an investment contract "because the return was in the form of fixed interest, guaranteed by the federal government." 577 F.2d at 563. The court recognized that, despite the fixed return and federal guaranty, purchasers of the note packages remained subject to investment risk. The federal guaranty was conditioned on the defendant's "care and diligence" in "making and collecting on the notes." *Ibid.* Investors were therefore dependent on the defendant's sound management and continued solvency, without which it would not be able to meet its obligations (*ibid.*), just as the investors in this case were dependent on ETS's continued solvency for ETS to be able to meet its lease-payment and repurchase obligations. The *Carman* court concluded that "[t]his risk of *loss* is sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed." *Ibid.* See also *SEC* v. *Eurobond Exch., Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994) (same, quoting *Carman*).

Other courts of appeals have similarly found instruments or schemes yielding fixed or contractually-guaranteed returns to be investment contracts, albeit without directly addressing the arguments accepted by the court of appeals here. See, *e.g.*, *SEC* v. *SG Ltd.*, 265 F.3d 42, 51 (1st Cir. 2001) ("flat 10% guaranteed return"); *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 234 n.2 (2d

Cir. 1985) (certificates of deposit paying fixed rates between 12.55% and 14.60%); *SEC* v. *Professional Assocs.*, 731 F.2d 349, 351, 355, 357 (6th Cir. 1984) (units in escrow account earning "interest" and trust accounts paying 9% annually); *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939) (contract promising 30% per annum return), cert. denied, 308 U.S. 622 (1940); *SEC* v. *Better Life Club of Am., Inc.*, 995 F. Supp. 167, 173-174 (D.D.C. 1998) (purported "loans" promising double the money invested), aff'd, 203 F.3d 54 (D.C. Cir.) (Table), cert. denied, 528 U.S. 867 (1999).[11]

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[11] In his brief in opposition to the certiorari petition (at 20), respondent relied on a line of cases holding bank "loan participations" not to be investment contracts Those cases are inapposite because they involved transactions of a primarily commercial, rather than investment, nature, and there were no sales to ordinary investors. Most of the cases involved transactions in which two or more financial institutions shared in making a commercial loan to a business. See, *e.g.*, *Kansas State Bank* v. *Citizens Bank*, 737 F.2d 1490, 1493-1495 (8th Cir. 1984); *Union Planters Nat'l Bank* v. *Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1181-1182 (6th Cir.), cert. denied, 454 U.S. 1124 (1981). Although those cases may have correctly held that the arrangements at issue were not investment contracts because of their commercial nature, cf. *Reves*, 494 U.S. at 66, the courts mistakenly relied on the fact that the lending banks expected to receive fixed returns. See, *e.g.*, *Kansas State Bank*, 737 F.2d at 1495; *Union Planters Nat'l Bank*, 651 F.2d at 1184-1185. In *Resolution Trust Corp.* v. *Stone*, 998 F.2d 1534, 1538-1540 (10th Cir. 1993), the court held that a savings and loan association did not purchase investment contracts when it bought commercial paper (known as "enhanced automobile receivables" or "EARs") consisting of "car loans purchased from automobile dealers and resold on the secondary market in a package [with] certain enhancements to insure collectability" (*id.* at 1536). In that case as well, the court incorrectly relied on the fact that the EARs paid a fixed return, but the court may have been correct that the EARs were not investment contracts when purchased in a commercial transaction by a financial institution. Cf. *Reves*, 494 U.S. at 66, 68. If, however, the EARs had been promoted as investments and sold to ordinary investors, they likely would have been investment contracts.

C. The SEC's Longstanding Interpretation Of "Investment Contract" As Including A Fixed- Or Guaranteed-Return Investment Is Entitled To Deference

The holdings of the courts of appeals that have rejected the view of the court below comport with the longstanding view of the SEC that an investment contract encompasses an arrangement paying a fixed or contractually guaranteed return. The SEC's view dates back to shortly after enactment of the securities laws. The SEC took that position in a civil enforcement action that it brought in 1936. In *SEC* v. *Universal Service Ass'n*, 106 F.2d 232 (1939), cert. denied, 308 U.S. 622 (1940), the Seventh Circuit upheld the SEC's charges in that enforcement action and ruled that various individuals, an association, and a corporation violated the Securities Act in the sale of investment contracts promising that, after five years, investors would receive their initial principal plus a 30% per annum return. The court concluded that the arrangement was a security because it fell within the definition proposed by the SEC—"[t]he investment of money with the expectation of profit through the efforts of other persons." *Id.* at 237.

The SEC has consistently adhered to the interpretation reflected in that early enforcement action. That interpretation has formed the basis for numerous other civil enforcement actions, *e.g.*, *Los Angeles Trust Deed & Mortgage Exch.* v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961), including actions against payphone sale/leaseback schemes just like respondent's, *e.g.*, *SEC* v. *Amtel Communications*,

Inc., 60 S.E.C. Dkt. 2080 (Nov. 7, 1995) ($51 per month lease payment); see 70 S.E.C. Dkt. 1605 (Aug. 30, 1999) (noting entry of final judgment).

The SEC has also advanced that interpretation in its briefs before this Court and in interpretive guidance. See, *e.g.*, Br. for the SEC as Amicus Curiae Supporting Petitioners at 28, *Reves*, *supra* (No. 88-1480); *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, SEC Release No. 33-3892 (Jan. 31, 1958) (noting that an "[i]mplied or actual guarantee of specified yield or return" is indicative of an investment contract); *Applicability of the Securities Laws to Multi-level Distributorships and Pyramid Sales Plans*, SEC Release Nos. 33-5211 & 34-9387 (Nov. 30, 1971) (stating that it is not "significant that the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise").

This Court has noted the SEC's interpretation in one of its decisions. That case, *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594 (1965), concerned the scope of Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 *et seq.* (1958). In recounting the factual history of the case, the Court explained that the company had started out by financing itself through the sale of tractor trailers to hundreds of small investors who simultaneously leased the trailers back to the company in exchange for "a set 2% of their investment per month for 10 years." 379 U.S. at 598. The Court further noted that the company halted that financing method because "the SEC advised [the company] that these sale and lease-back arrangements were investment contracts and therefore securities" subject to the registration requirements of the Securities Act. *Ibid.*

Most significantly, the SEC's interpretation is embodied in at least two formal adjudications. In *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), *available in* 1969 WL 95359, order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,813, at 90,056 (D.C. Cir. Sept. 25, 1970), the Commission ruled that mortgage notes—which provided a fixed rate of interest as the return—were investment contracts when they were sold together with management services and a pledge to repurchase the notes in the event of default. The Commission noted that the sales literature touted the "guarantee" of the notes by the company and concluded that the purchasers were "rel[ying] upon the services and undertakings of others to secure the return of a profit." 1969 WL 95359, at *4.

Similarly, in *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), *available in* 1982 WL 522493, the SEC held that promissory notes secured by deeds of trust on real property and sold with a package of management services were investment contracts. The Commission noted that the promoter solicited investors with the promise that they would receive "a specified percentage return on their investment depending upon the market at the time the loan is made" and the representation that "[t]he return currently being offered is about 16 percent." 1982 WL 522493, at *2.

The SEC's interpretation of the securities laws reflected in those adjudications is entitled to deference under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). See *SEC* v. *Zandford*, 535 U.S. 813, 819-820 (2002) (citing *United States* v. *Mead Corp.*, 533 U.S. 218, 229-231 & n.12 (2001)). The SEC's interpretation is reasonable for the reasons described earlier in this brief, and should be sustained by this Court.

D. The Court Of Appeals' Holding Is Unsupported And Would Frustrate The Purposes Of The Securities Laws

1. The exclusion of fixed-return investments is not required by Forman *or* Reves

a. The court of appeals did not adhere to the SEC's interpretation of "investment contract" because the court concluded that this Court, in *Forman*, had limited the meaning of "profits" under the *Howey* definition of investment contract to exclude fixed returns. See Pet. App. 3a-7a. That conclusion was mistaken.

In *Forman*, the Court, describing its holdings in prior investment contract cases, stated: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment * * * or a participation in earnings." 421 U.S. at 852. The Court's reference to "a participation in earnings" did not create a new test that narrowed *Howey* to variable return investments. The Court was simply describing one of its prior cases (*Tcherepnin*), and it did not thereby hold that no other kind of return can constitute profits.

The basic point of the Court's reference in *Forman* to capital appreciation or a participation in earnings was to distinguish the situation in which an investor is "'attracted solely by the prospects of a return' on his investment," which involves a security, from a situation in which "a purchaser is motivated by a desire to use or consume the item purchased," which does not involve a security. 421 U.S. at 852-853 (citation omitted). Thus, in *Forman*, where low-income purchasers received stock entitling them to lease an apartment in a state-subsidized and supervised non-profit housing cooperative, the Court concluded that there was no investment contract because purchasers "were attracted solely by

the prospect of acquiring a place to live, and not by financial returns on their investments." *Id.* at 853. In this case, by contrast, investors in the ETS scheme were motivated by the prospect of a financial return on the purchase price of the payphone packages rather than a desire personally to use the payphones. See Pet. App. 6a (noting that ETS investors purchased the payphone packages "for the purpose of earning a return on the purchase price"); *id.* at 22a (stating that "[i]nvestors never saw the telephones" and "never used the telephones").[12]

Moreover, there is no indication in *Forman* that the Court understood "a participation in earnings" as limited to a variable return. On the contrary, the Court made clear that "profit may be derived from the *income* yielded by an investment," 421 U.S. at 855 (emphasis added), and that the essence of the test is whether "the investor is 'attracted solely by the prospects of a *return*' on his investment," *id.* at 852 (emphasis added) (citing *Howey*, 328 U.S. at 300). The Court also sometimes equated "profits" with "financial *returns*" and with "*income* or profits." See *id.* at 853, 855 (emphasis added). And, in the course of its analysis, the Court stated that "one might readily agree that net *income*

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[12] The court of appeals' statement that "capital appreciation is not at issue" in this case (Pet. App. 7a) is incorrect. Respondent himself claimed that the value of the payphone packages increased over time. See J.A. 162-163, 183. Promotional materials also implied that the payphone interest being offered was a "valuable asset" that would "increase[] in value." See J.A. 96. And the record suggests that investors expected returns in the form of capital appreciation (as well as in the form of the monthly payments). See J.A. 92-93 (statement by ETS investor that he believed there was a possibility that the payphone package would increase in value over time).

from the leasing of commercial and professional facilities is the kind of *profit* traditionally associated with a security investment." *Id.* at 856 (emphasis added). The terms "income" and "return" (like the term "profit" itself) are not limited to variable yields. See p. 17, *supra*; *Webster's New Int'l* at 2130; *Webster's Third* at 1941.

Nor is the ordinary meaning of the phrase "a participation in earnings" limited to a variable return. An investor can have a "participation" in the "earnings" of an enterprise even when his return is not *measured* by those earnings. Irrespective of the measure of the return, an investor expects a "participation" in "earnings" when, as in this case, he is led to believe that the *source* of his return will be the company's earnings. Cf. *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) (describing fixed payments promised to investors for bringing in new investors as "a share in the proceeds" of the business). Thus, the statement in *Forman* on which the court of appeals relied in this case did not narrow the *Howey* definition of investment contract.

b. The *Howey* definition also was not narrowed by the Court's characterization in *Reves* of its statement in *Forman*. In *Reves*, the Court established the test for determining whether an interest denominated as a note is a security. In so doing, the Court concluded that the *Howey* test did not govern that question, and the Court stated that "the *Howey* test is irrelevant to the issue before us today." 494 U.S. at 64, 68 n.4. In describing the "irrelevant" *Howey* test, however, the Court, citing *Forman*, stated that "profit," as used in that test, had been defined "restrictively" in a way that would "suggest" that "a rate of interest not keyed to the earnings of the enterprise" would not constitute "profit." *Id.* at

68 n.4. The meaning of the *Howey* test was not, however, before the Court in *Reves*. The Court therefore had no occasion to (and did not purport to) alter its meaning. Nor is it likely that the Court would have done so in a footnote containing no elaboration on the point.

It bears note as well that the Court in *Reves* was careful to say only that the *Forman* language "suggest[ed]" the need for a return keyed to earnings. The Court did not say that the *Forman* language definitively meant that such a return is required. In any event, even if the Court's statement in *Reves* did reflect the view that *Howey* "profits" must be keyed to earnings, the Court was merely characterizing the way it believed *Forman* had interpreted the *Howey* test. As the discussion above illustrates, such a characterization of *Forman* (and *Howey*) would be mistaken, and should not be adopted here. Compare *Landreth*, 471 U.S. at 691 n.5 (declining to read broadly dicta concerning the *Howey* test in a footnote in another decision of the Court, *Teamsters* v. *Daniel*, 439 U.S. 551, 558 n.11 (1979) (quoting *Forman*, 421 U.S. at 852)).

2. There is no support for the court of appeals' conclusion that profits that are contractually guaranteed are not expected to come from the efforts of others

In addition to relying on the fixed nature of the investment return, the court of appeals also held that profits that are an "entitle[ment] * * * under their contracts" and thus "contractually guaranteed" cannot meet the *Howey* test. Pet. App. 8a. The court reasoned that such profits cannot satisfy the requirement that they be expected to come "from the efforts of others" (*Howey*, 328 U.S. at 301), because they are

instead "derived as the benefit of the investors' bargain under the contract." Pet. App. 8a.

Neither logic nor precedent supports that conclusion. As a logical matter, the fact that investors have bargained for a return in their investment agreement does not mean that the return is not also expected to come from the efforts of others. If it did, virtually no investment agreement would qualify as an "investment contract" because investors almost always obtain the promise of a return in exchange for parting with their money. If the promised return is to come from a business enterprise in which the investors are not active participants, then the return is expected to come from the efforts of others, since effort by *someone* will be necessary to produce the return. Absent the efforts of others, the investors will not receive the return—whether or not they are legally entitled to it as the benefit of their bargain.

The Court's cases are fully consistent with that understanding of what it means for profits to be expected from "the efforts of others." *Howey*, 328 U.S. at 301. *Howey* makes clear that the focus of that aspect of the investment contract definition is on whether someone other than the investors themselves manages the enterprise that is expected to generate the money that will fund the return. See *id.* at 300 ("manage-[ment] by [the promoters] or third parties with adequate personnel and equipment [was] therefore essential if the investors [we]re to achieve their paramount aim of a return on their investments"). Whether or not the investor's return was promised in the contracts was irrelevant to the Court's analysis. In fact, the investors in *Howey* were entitled to their returns under the contracts they had with the promoters. See *id.* at 296 (noting that, under the service contracts with investors,

the company was "accountable * * * for an allocation of the net profits" from cultivation and sale of the fruit).

In this case, the complaint—the allegations of which the Court must accept as true (see note 1, *supra*)—stated that "[i]nvestors under the lease program have no involvement in the operation of the pay telephone site" and that "ETS manages and maintains the payphones, including interior and exterior maintenance as well as coin retrieval." J.A. 11. Moreover, the district court found that respondent "manage[d], maintain[ed], and operate[d] the pay phones" and that "investors retain[ed] little, if any, control." Pet. App. 17a. The court of appeals did not conclude that the district court's finding concerning the investors' lack of control was clearly erroneous. Indeed, the court of appeals recognized that "the funds generated by the payphones [through ETS's management] helped ETS meet its [lease and buyback] obligations." *Id.* at 7a. Under *Howey*, the fact that investors expected to have no role in managing their phones and to receive their returns from the earnings generated by respondent's efforts in managing ETS established that they expected to receive their returns "from the efforts of others" (328 U.S. at 301).[13]

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[13] The district court's factual findings are not directly at issue here, because the court of appeals ordered the case dismissed based on the allegations of the complaint. Nonetheless, contrary to the court of appeals' statement that "[t]he parties dispute the level of control over the telephones the investors retained under the leaseback agreements" (Pet. App. 7a), there was no real dispute that investors who chose the leaseback arrangement (99% of all investors, see J.A. 164) expected to be passive investors who would receive their returns from funds generated by the efforts of others. See, *e.g.*, J.A. 78 (statement by an investor that he expected to have no role in managing his phones), J.A. 239 (same).

3. The limitations imposed by the court of appeals would open a loophole in the securities laws

There would be a serious gap in investor protection if this Court were to accept the interpretation of "investment contract" reflected in the court of appeals' decision. That interpretation would preclude the Commission from bringing enforcement actions based on fraudulent investment contract schemes that promised fixed or "contractually guaranteed" returns. It would also bar private actions under the securities laws based on such fraud. There is no reason to open such a significant loophole in the securities laws.

As explained above, the phrase "investment contract" was included in the statutory definition of a security as a catch-all for investments that do not fit easily into the other categories listed. The "investment contract" category has served as a critical means of bringing a host of unconventional financial arrangements—offering both fixed and variable returns—within the purview of the federal securities laws. See cases cited at pp. 21-30 & note 9, *supra*. The Commission continues to bring many injunctive and administrative actions each year in which the schemes involve investment contracts with fixed or guaranteed returns. In fiscal year 2002 alone, the SEC instituted more than

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ETS investors expected their monthly payments to come out of revenue generated by respondent's efforts in managing their phones because the program was advertised that way. See, *e.g.*, J.A. 119 (touting "profits" for owners of payphones through ETS's management); J.A. 124 (same); J.A. 223 (same); J.A. 231 (telling prospective investors that ETS's efforts "will allow you to become detached from the day-to-day demands of the payphone business").

thirty actions involving investment contracts offering fixed or contractually guaranteed returns.[14]

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[14] See *In re Donald D. Lukens*, Admin. Pro. File No. 3-10894 (instituted Sept. 20, 2002); *SEC* v. *Eisenberg*, No. CV 02-6479 AHM (JTLx) (C.D. Cal. compl. filed Aug. 20, 2002); *SEC* v. *Lefebvre*, No. C-02-3704-MEJ (N.D. Cal. compl. filed July 31, 2002); *In re Raphael Levy*, Admin. Pro. File No. 3-10822 (instituted July 9, 2002); *In re Gerald Cohn*, Admin. Pro. File No. 3-10826 (instituted July 9, 2002); *In re Douglas C. Brandon*, Admin. Pro. File No. 3-10799 (instituted June 12, 2002); *SEC* v. *Gold-Ventures Club*, No. 1:02-CV-1434(CAP) (N.D. Ga. compl. filed May 28, 2002); *SEC* v. *Watts*, No. 5-02-CV-0109-C (N.D. Tex. compl. filed May 21, 2002); *SEC* v. *Starcash, Inc.*, No. 02-80456-CIV (S.D. Fla. compl. filed May 16, 2002); *SEC* v. *Americash-Inc.com*, No. 02-CV-80457 (S.D. Fla. compl. filed May 16, 2002); *SEC* v. *U.S. Funding Corp.*, No. 2:02cv2089 (D.N.J. compl. filed May 2, 2002); *SEC* v. *4NExchange, LLC*, No. 2:02CV-431K (D. Utah compl. filed May 2, 2002); *SEC* v. *Corriere*, No. 8:02-CV-666-T17EAJ (M.D. Fla. compl. filed Apr. 18, 2002); *SEC* v. *Herula*, C.A. No. 02 154 ML (D.R.I. compl. filed Apr. 1, 2002); *SEC* v. *Gilliland*, No. 3:02CV128-H (W.D.N.C. compl. filed Mar. 27, 2002); *SEC* v. *Dunbar*, No. 02-233 (M.D. La. compl. filed Mar. 4, 2002); *SEC* v. *CDH & Affiliates, Inc.*, No. 3:02cv00017 (N.D. Ga. compl. filed Feb. 25, 2002); *SEC* v. *Goldstein*, No. 302048517 (D.S.C. compl. filed Feb. 14, 2002); *SEC* v. *Tyler*, No. 3:02-CV-0282-P (N.D. Tex. compl. filed Feb. 11, 2002); *SEC* v. *Moody*, No. 2:02CV-0110B (D. Utah compl. filed Feb. 6, 2002); *SEC* v. *McConnell*, C.A. No. 02 0075 RCL (D.D.C. compl. filed Jan. 16, 2002); *SEC* v. *Dillie*, No. CV-01-2493-PHX-JAT (D. Ariz. compl. filed Dec. 20, 2001); *SEC* v. *Invest Better 2001*, No. 01 Civ. 11427 (S.D.N.Y. compl. filed Dec. 13, 2001); *SEC* v. *Willy*, No. EDCV01-979VAP(SGLx) (C.D. Cal. compl. filed Dec. 5, 2001); *SEC* v. *Taylor*, No. 3:01-CV-2683-X (N.D. Tex. compl. filed Dec. 20, 2001); *SEC* v. *BIJ Fin. Servs.*, C.A. No. 01-Z-2322 (D. Colo. compl. filed Dec. 3, 2001); *SEC* v. *Lukens*, No. CV 01-09410 SVW (AJWx) (C.D. Cal. compl. filed Nov. 1, 2001); *SEC* v. *Texon Energy Corp.*, No. 2:01cv09706 (C.D. Cal. compl. filed Nov. 13, 2001); *SEC* v. *Hill*, No. 3:01-CV-2189-X (N.D. Tex. compl. filed Oct. 31, 2001); *SEC* v. *Bentley*, No. 2:01-CV-053-66-JF (E.D. Pa. compl. filed Oct. 23,

Excluding such unconventional investments from the scope of the securities laws because they offer a fixed return or are "contractually guaranteed" would be a radical departure from the enforcement history under those laws and would significantly impair the SEC's ability to protect investors from securities fraud. Indeed, the court of appeals' decision provides a blueprint for unscrupulous promoters to circumvent the securities laws by structuring the returns offered by their investment schemes as fixed or contractually guaranteed amounts even though the investments function economically like other investments sold to raise capital. That result would frustrate Congress's "intent to regulate the entire body of instruments sold as investments." *Reves*, 494 U.S. at 64. And it would have a disproportionate impact on those who are most likely to fall victim to fraud—unsophisticated and elderly investors, to whom fixed- and guaranteed-return investments have particular appeal.[15]

2001); *SEC* v. *Chiarella*, No. 3:01-CIV-2037-G (N.D. Tex. compl. filed Oct. 10, 2001).

[15] Even if the court of appeals were correct in its narrow interpretation of the term "investment contract," it still would have erred in ordering the SEC's complaint dismissed for lack of subject matter jurisdiction. The complaint alleged not only that the payphone packages were investment contracts but also more generally that they were "securities." J.A. 12. The SEC argued in the district court that the packages qualified as securities both because they were investment contracts and because they were "note[s]" or "evidence[s] of indebtedness." 15 U.S.C. 77b(a)(1), 78c(a)(10). Although those terms are less flexible and do not describe the payphone investments as well as the term "investment contract," the Commission might well be able to establish that the payphone investments fit within those terms or that they qualify as "instrument[s] commonly known as * * * 'securit[ies].'" 15 U.S.C. 77b(a)(1), 78c(a)(10). The court of appeals should have remanded for the district court to consider whether the case could proceed on one of those alternative theories. See *Meason* v. *Bank of Miami*, 652 F.2d 542, 547-548, 550-551 (5th Cir. 1981) (reversing dismissal of complaint for lack of subject matter jurisdiction and remanding for consideration whether certificate of deposit was some kind of security other than an investment contract), cert. denied, 455 U.S. 939 (1982).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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In The Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

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QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definition of "security" under Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Charles E. Edwards submits that he does not have any parent corporations or subsidiaries.

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STATEMENT

Respondent Charles E. Edwards was the founder and controlling shareholder of ETS Payphones, Inc. ("ETS"), a Georgia corporation that has been in the business of operating and leasing coin-operated pay telephones since approximately 1994. ETS grew substantially after Congress and the Federal Communications Commission effected major regulatory changes in the pay telephone business in 1996. J.A. 48, 65-66, 151, 242-243. Until June 2000, Respondent was a member of ETS's board of directors and served as its chief executive officer. J.A. 47-48, 242. At that time, ETS had twenty-eight offices nationwide and four in Mexico, 550 employees, and was operating 47,000 pay telephones, almost all as lessee or owner, in more than thirty-five states. J.A. 58-59, 155, 168-169, 177. ETS was one of the largest privately owned payphone operators in the country. J.A. 155. ETS offered "business opportunities" subject to regulation by the Federal Trade Commission's ("FTC") disclosure regulation rule "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures." *See* 16 C.F.R. § 436 (2003). ETS provided a disclosure brochure as required by the FTC regulations to those pay telephone owners dealing with ETS (the "FTC brochure"). J.A. 121-147, 256.[1]

Respondent devoted significant resources to ensure ETS's compliance with federal, state and local laws. J.A.

[1] Business arrangements like that of ETS come within the definition of a "business opportunity" according to federal law and are subject to the enforcement authority of the FTC. *See, e.g., FTC v. Tashman*, 318 F.3d 1273 (11th Cir. 2003); *FTC v. H.N. Singer, Inc.*, 668 F.2d 1107 (9th Cir. 1982).

56, 62, 243-244, 256-257. He relied upon the legal expertise of multiple lawyers and accountants that advised him regarding ETS's corporate structure and business, including obtaining legal opinions regarding the issue of whether ETS's business involved the sale of a security. J.A. 56, 256-258, 280-282. In 1995, Respondent and his attorney had meetings with an SEC official to respond to questions in an informal investigation initiated by the SEC regarding that issue. They presented numerous documents and records, discussed ETS's pay telephone business and corporate structure in some detail, and explained ETS's plans to separate its marketing of telephones from its leasing business in order to assure compliance with the federal securities laws. J.A. 57, 62, 159, 257, 280-281. The SEC took no action against ETS or Respondent as a result of that investigation. J.A. 64, 258; Pet. App. 3a n.1.

One result of the SEC's 1995 investigation was Respondent's decision to establish Payphone Systems Acquisitions, Inc. ("PSA"). J.A. 244, 246. PSA, initially a sister corporation and later wholly owned by ETS, was formed to purchase pay telephone equipment and sell it to independent distributors who would actually market pay telephones through professional brokers, insurance agents and others, along with various other products and services of their own, such as life insurance. J.A. 58, 246-247. The prices of equipment changed over time; however, during 2000, PSA acquired telephones from manufacturers and from existing operators at prices ranging from approximately $2,750 to $3,700, frequently adding upgrades averaging $1,200, and sold them at wholesale to distributors for $5,250. J.A. 247-251. ETS was not involved in the sale of pay telephones, but part of its business was acquiring telephone site locations from commercial property owners, such as convenience store chains, stadiums, and gas stations, where pay telephones could be installed in

exchange for a percentage of the revenue or profits from those pay telephones. J.A. 48, 160, 175-177, 221-222.

In accordance with the business plan explained to the SEC in 1995, the independent distributors and ETS used separate marketing campaigns directed to their respective needs. J.A. 94-109, 111-121, 246. The independent distributors created and provided their own informational packages, which described the profitability of the pay telephone industry and the typical options available to a new pay telephone owner for commercial use of the telephone. J.A. 94-109, 246. On the other hand, ETS's materials either were directed to the property site owners, explaining why it would be profitable to agree to permit ETS to install pay telephones at their commercial establishments, J.A. 48, 111-121, 168, or the FTC brochure was sent upon request to telephone owners who were prospective customers for ETS's service and leasing business. J.A. 122-148, 168, 187, 252. ETS's website contained a discussion of the pay telephone industry, the equipment, and of ETS's business. J.A. 223-228. It did not anywhere state that lessors could expect to share in "profits" from ETS. Other website materials were posted by distributors, not ETS. J.A. 231-238.

The leasing aspect of ETS's business was conducted through typical commercial leasing arrangements, with a normal exchange of lessor-lessee duties and responsibilities whereby the owner retained full ownership and property rights to the asset, with the five-year cancelable lease giving ETS full authority over the monitoring, management, and maintenance of the pay telephones and all rights to the revenue. J.A. 269-276. These leases were standard equipment leases, not management agreements. J.A. 134-141. An individual purchasing a pay telephone

and right to a site location from the independent distributor paid approximately $6,750 in 2000. J.A. 110. The new owner could rescind the purchase for any reason within fifteen days at no penalty. J.A. 110, 252. Failure to provide the pay telephone would also lead to a full refund. J.A. 110. The options for commercial use of which pay telephone owners were informed, included personal operation without use of a service company. J.A. 83, 103 (Option 1). The owner could also contact ETS, or any of the many other pay telephone management and leasing companies, to obtain pay telephone management services. J.A. 168, 187-189, 246, 255. If contacted, ETS would then provide the owner with the FTC brochure describing its "Payphone Equipment Lease Program" and the other service contracts available from ETS. J.A. 122-148, 168, 187, 252. ETS did not market its services to prospective pay telephone owners, as it became involved in the transaction *after* an individual purchased a pay telephone from an independent distributor. J.A. 48, 246, 252.[2] As described in the FTC brochure, ETS offered three options to pay telephone owners. J.A. 122-148, 253. The first two options were service contracts, under which ETS would perform specified technical services for a fee with the telephone owner performing business services and realizing the income potential of his or her particular pay telephone(s). J.A. 126-128, 253. The SEC does not contend these business arrangements are investment contracts.

The third option, and the only option at issue here, is the "Payphone Equipment Lease Program" option. J.A.

[2] Beginning in 2000, independent distributors that were properly registered under the relevant states' "Business Opportunity" laws could provide the ETS FTC brochure to the prospective purchaser at the point of sale. J.A. 247, 252.

128, 253. This option was for owners who did not want day-to-day involvement in the business of operating a pay telephone and who wanted to eliminate the fluctuation of the revenue stream related to their pay telephone. J.A. 128, 254. Under the lease program, the owner leased the pay telephone equipment to ETS under a cancelable lease agreement for a five-year term for a monthly lease payment that was fixed for the term of the particular lease and any renewals. J.A. 254, 269. By 2000, new leases carried a fixed monthly rental rate of $82.00. J.A. 254, 269. After an owner signed a lease agreement with ETS, the owner would receive an addendum from ETS identifying the site where the leased telephone was located. J.A. 191, 194. The notification of the location usually took two or more weeks due to changing inventory, replacing equipment, and the general operations and administrative aspects of the business. J.A. 190, 195. The lessor received rent payments from the commencement of the lease. J.A. 134, 269.

Since the owner had leased the pay telephone to ETS, ETS as lessee collected and kept any revenue produced by the pay telephone, shouldered any expenses incurred, and retained the right to relocate the telephone to a more profitable location if necessary, with notice to the owner. J.A. 135-136. ETS assumed the risk that the pay telephone might not be profitable. The lessor received only the fixed monthly rental amount provided in the agreement, and ETS's payment of this rent could derive from any source of funds at its disposal. J.A. 269. The lease agreement gave the lessors the right to assign, the right to switch to a service plan rather than lease, and the right to sell the equipment to ETS at the original purchase price

upon 180 days written notice. J.A. 272-273.[3] The lessors could also cancel their lease and take possession of their pay telephone, with no penalty, upon 90 days written notice to ETS. J.A. 255, 269. If ETS defaulted by non-payment of rent, the lessor could terminate the lease and take immediate possession of the equipment or, without terminating the lease, take possession of the equipment and re-let, with ETS being responsible for any deficiency. J.A. 255, 271-272.[4] Because the lessors could readily recover their equipment for non-payment, the only risk they faced from default under the lease agreement was the loss of the benefit of their bargain with ETS.

Of those pay telephone owners contracting with ETS, almost all chose the leasing option. J.A. 254. The lessors expressly acknowledged that they were not required to use ETS as their leasing company, nor were they required to sign a lease agreement as a condition of purchase. J.A. 273 (Par. 18). Neither the service plans nor the lease arrangement entitled a telephone owner to a share or financial interest in ETS, or profit from its future development, or to share in any profits that ETS generated by managing the collective group of pay telephones that it owned or leased or in any profits it generated from other business activities. J.A. 126-129.

Until ETS voluntarily filed for reorganization under Chapter 11 of the Bankruptcy Code in September 2000, it

[3] In ETS's experience, only about one percent of lessors exercised this buy-out option. J.A. 181.

[4] The terms of the ETS lease agreement are typical of those in standard commercial equipment lease agreements. *See, e.g.*, William B. Piels, *Doing Deals 2003: Understanding the Nuts & Bolts of Transactional Practice in an Uncertain Market, Equipment Leasing*, 1356 PRAC. L. INST. 577, 635-665 (2003) (selected form equipment lease provisions).

never missed a rental payment owed to a lessor. J.A. 91. ETS's plan of reorganization was confirmed on November 14, 2001, and resulted in ETS's continuing operations and the ongoing management of tens of thousands of pay telephones. In accordance with the plan of reorganization, Respondent no longer has any interest in or connection to ETS. Findings of Fact, Conclusions of Law and Order Confirming the Joint Reorganization Plan of PSA, Inc., ETS Payphones, Inc. and ETS Vending, Inc., et al., *In re PSA, Inc.*, Ch. 11 Case No. 00-3570 (KJC) (Bank. D. Del. filed Sept. 11, 2000) (No. 1973).

On September 29, 2000, after ETS filed its bankruptcy petition, and five years after first learning the details of ETS's business from Respondent, the SEC filed an enforcement action against ETS and Respondent under the federal securities laws alleging that ETS sold "investment contracts," that the investment contracts were not registered and that misleading statements about ETS's financial condition had been made in connection with the investment contract sales.[5] Although not relevant to the issue before the Court, the SEC addresses at some length the allegations it made that ETS and Respondent had engaged in violations of the federal securities laws' anti-fraud provisions. SEC Brief 4-6.[6] Respondent contested

[5] The SEC alleged violations of 15 U.S.C. § 77q(a), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (2003), and 15 U.S.C. §§ 77e(a) and 77e(c). J.A. 15-20.

[6] In one particular, the SEC states that on July 1, 2000, Respondent wrote a letter to "investors" misrepresenting that ETS was "profitable." SEC Brief 5. The letter, addressed to "leaseholders," responded to questions posed by them regarding ETS. J.A. 229. Respondent explained that ETS's revenue from payphones was down overall because of the problems collecting for certain types of calls and that ETS profited by $8.7 million in 1999. J.A. 230. The figures

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these allegations. J.A. 24-34, 36, 242-268. In light of its disposition of the case, the court of appeals did not address the SEC's allegations or Respondent's challenge to them, and they should not be allowed to influence the consideration of the issue before the Court.[7]

On November 22, 2000, after a brief evidentiary hearing, the district court granted the SEC's emergency petition against Respondent, entering an asset freeze, a preliminary injunction and other equitable relief. Pet. App. 27a. The district court concluded that ETS was selling unregistered investment contracts while failing to disclose the true financial condition of the company.[8] Pet. App. 17a-18a. The

presented by the SEC (SEC Brief 5), suggesting extensive operating losses and ETS's lack of profitability, are reached using accounting conventions ETS was not required to and did not utilize in preparing its financial statements. J.A. 45-46, 259. Contrary to the SEC's assertion, Mr. Edwards never testified that he was aware of ETS's poor financial condition. SEC Brief 5.

[7] *See, e.g., United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 859 (1975) (noting that the fraud claims would not be addressed where court determined there was no subject matter jurisdiction).

[8] The SEC continues to state as a "fact" that "ETS took in approximately $300 million from more than 10,000 investors." SEC Brief 4. The SEC's citation to the district court and court of appeals opinions for this statement is erroneous. It is not in the district court's opinion, and the court of appeals was merely restating the SEC's own characterization. Pet. App. 3a, 23a. The SEC also erroneously contends that the allegations of the SEC's complaint must be taken as true. SEC Br. 3 n.1. Respondent's opposition to subject matter jurisdiction, pursuant to FED. R. CIV. P. 12(b)(1), was a factual challenge, not a facial one by a motion to dismiss pursuant to FED. R. CIV. P. 12(b)(6). *KVOS, Inc. v. Associated Press*, 299 U.S. 269, 278 (1936); *Garcia v. Copenhaver, Bell & Associates, M.D.'s*, 104 F.3d 1256, 1260 (11th Cir. 1997); *Turicentro, S.A. v. American Airlines Inc.*, 303 F.3d 293, 300 n.4 (3d Cir. 2002). Because Respondent did not accept the SEC's statement of facts in the complaint and challenge the claim for relief under an applicable statute, FED. R. CIV. P. 12(b)(6) did not apply. Therefore, the Court's

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asset freeze extended to all of Respondent's assets and to his non-defendant companies' assets, not just those traceable to the alleged security offerings. Pet. App. 27a. The district court's decision spawned numerous federal court private securities actions by lessors.[9]

Respondent's appeal asserted a number of errors, including lack of subject matter jurisdiction because the SEC had not proven that the business arrangements

approach to the "facts" in *SEC v. Zandford*, 535 U.S. 813 (2002) and *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83 (1998) is not applicable here. Nor does *Saudi Arabia v. Nelson*, 507 U.S. 349 (1993) support the SEC's contention that the allegations of the complaint are to be taken as true as that decision did not address the nature of the motion that led to the order under review. Respondent's factual challenge was based upon all of the materials before the district court, including those proffered at the limited evidentiary hearing, and the court of appeals considered this evidence in determining subject matter jurisdiction. *Menchaca v. Chrysler Credit Corp.*, 613 F.2d 507, 511 (5th Cir. 1980), *cert. denied*, 449 U.S. 953 (1980); *Turicentro, S.A.*, 303 F.3d at 300. Throughout its brief here, the SEC has relied upon those materials as well. Accordingly, no presumptive truthfulness attaches to the allegations in the complaint. *Valentin v. Hospital Bella Vista*, 254 F.3d 358, 363 (1st Cir. 2001); *Williamson v. Tucker*, 645 F.2d 404, 413 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

[9] *Dassero, et al. v. Edwards, et al.*, No. 01-CV-6269 (W.D.N.Y. filed May 29, 2001); *May, et al. v. Edwards, et al.*, No. 8:01-CV-571-T-30 (M.D. Fla. filed March 15, 2001); *White, et al. v. Edwards, et al.*, No. 8:01-CV-569-T-30 (M.D. Fla. filed March 15, 2001); *Key, et al. v. Edwards, et al.*, No. 1:01-CV-0451 (N.D. Ga. filed Feb. 15, 2001); *Chissler, et al. v. Edwards, et al.*, No. 8:01-CV-262-T-26 (M.D. Fla. filed Feb. 5, 2001); *Dunstan, et al. v. Edwards, et al.*, No. 8:01-CV-265-T-30 (M.D. Fla. filed Feb. 5, 2001); *Earl, et al. v. Edwards, et al.*, No. 8:01-CV-267-T-30 (M.D. Fla. filed Feb. 5, 2001); *Higginbotham, et al. v. Edwards, et al.*, No. 8:01-CV-263-T-30 (M.D. Fla. filed Feb. 5, 2001); *McCormick, et al. v. Edwards, et al.*, No. 3:01-CV-146-J-25 (M.D. Fla. filed Feb. 5, 2001); *Porter, et al. v. Edwards, et al.*, No. 8:01-CV-264-T-30 (M.D. Fla. filed Feb. 5, 2001) and *Skidmore, et al. v. Edwards, et al.*, No. 8:01-CV-266-T-30 (M.D. Fla. filed Feb. 5, 2001).

between ETS and the lessors were investment contracts. The court of appeals stated that in order to defeat Respondent's jurisdictional challenge to the preliminary injunction, the SEC had to establish a reasonable probability of ultimate success upon the question of jurisdiction when the action is tried on the merits. Pet. App. 4a. The court of appeals reversed, concluding that there was no subject matter jurisdiction to entertain the action as the SEC had not shown that it could satisfy the third element of what defines an investment contract under the test established in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the expectation of profits solely from the efforts of others. Pet. App. 6a. The court of appeals reasoned that the SEC could not demonstrate that the pay telephone owners expected "profits" in accordance with *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). Pet. App. 6a. Relying upon *Forman*, the court of appeals noted that the definition of profits has a limited meaning in the context of investment contracts, requiring that the investor have either a participation in the earnings on his investment or an opportunity for capital appreciation. Pet. App. 6a-7a. The court noted that "there is no dispute that capital appreciation is not at issue"[10] and concluded that the fixed

[10] In its Brief, the SEC now contends that payphone purchasers had a reasonable expectation of profit from ETS in the form of capital appreciation. SEC Brief 35 n.12. The SEC did not allege this in its complaint, nor did it argue this at the evidentiary hearing before the district court, or before the court of appeals, not even on rehearing, or in its petition for certiorari. Its argument should not be considered here. *See, e.g., Department of Treasury, IRS v. Federal Labor Relations Auth.*, 494 U.S. 922, 934 (1990). In any event, nothing the SEC relies upon supports its claim that capital appreciation was a reasonable expectation of a pay telephone lessor. The materials that described the pay telephones as a valuable asset are accurate, but lend no credence to the

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lease payments were not a participation in earnings "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." Pet. App. 7a. The court explained that "only ETS could reap profits as that term is understood under the federal securities law." Pet. App. 7a. Finally, the court noted that even if "profits" were found here, the second aspect of the third element of the *Howey* test remained unsatisfied; the "investors did not expect profits to be derived solely from the efforts of others" since the rental payments "were derived as the benefit of the investors' bargain under the contract." Pet. App. 7a-8a. Judge Lay, in his concurring opinion, noted that ETS "dutifully managed the phones it leased for the duration of its existence and continues to do so today under its reorganization plan," and "that ETS made a good faith effort to run a legitimate business." Pet. App. 14a.

After the SEC's petition for rehearing and rehearing *en banc* were denied, Pet. App. 28a-29a, and while the SEC's since-denied motion to stay the mandate was pending, the government seized Respondent's assets under a claim of civil forfeiture, in effect continuing the asset freeze ordered dismissed by the court of appeals. SEC Brief 6 n.3. Mr. Edwards is contesting this seizure.

claim of appreciation in value of the equipment as a benefit of the ETS-lessor relationship. Respondent did not describe "payphone packages" as increasing in value over time. SEC Brief 35 n.12. He did explain his belief that ETS's locations increased in value when advertising was displayed on the pay telephone booth, but that value belonged only to ETS, not the lessor. J.A. 183. Any expectations about the increase in value of the pay telephones was mere speculation. J.A. 93.

SUMMARY OF ARGUMENT

This case requires the Court to address once again the elements of the well-established test for determining whether an instrument is an "investment contract" and therefore falls within the statutory definition of "security" contained in the Securities Act and the Securities Exchange Act. In particular, the Court must decide whether the term "investment contract" has a settled interpretation with uniform characteristics such that those engaging in business arrangements can discern the legal contours of the term, or whether, as urged by the SEC, the term is sufficiently "accommodating" so that it may be used as a basis for *post hoc* enforcement initiatives directed against arrangements not having those uniform characteristics. Investment contracts have been viewed uniformly as having the variable "profit" attributes of an equity security; they do not include the fixed return attributes traditionally associated with debt securities.

The question presented by the SEC in the Petition is different than the issue ruled upon by the court of appeals. See Resp. Opp. to Pet. page 11. The court of appeals held that the fixed payments made by ETS to lessors of the pay telephones pursuant to the lease agreements did not represent either capital appreciation or a participation in the earnings of the enterprise and therefore were not the type of "profits" the Court has found in instruments that

are investment contracts. The Court has twice before addressed this issue, explaining how the "profits" element of the investment contract test it announced in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), was to be construed. In *Howey*, the Court held that the "test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *See id.* at 301. Later, applying the "profits" element of the *Howey* test, the Court in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975) stated that: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds. . . . " Fifteen years later, in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Court addressed the meaning of "profits" in a somewhat broader context under the securities laws, and again stated, unanimously, that "profits" in the context of an investment contract had a more restrictive definition than it had in an analysis to determine whether other types of securities were present. The Court noted that it had "defined 'profit' more restrictively in applying the *Howey* test to what are claimed to be 'investment contracts,'" to encompass only capital appreciation and a participation in earnings. *Id.* at 68 n.4.

The SEC challenges the Court's prior decisions as not correctly reflecting the proper test for the profits element of the *Howey* test. The SEC argues that a "fixed" payment meets the *Howey* test, eschewing the Court's twice-stated formulation. The SEC fails in its effort to demonstrate that the Court erred in assessing Congressional intent in *Howey*, *Forman* and *Reves*. Indeed the SEC seeks to "expand the realm of *Howey*" (*Reves*, 494 U.S. at 68 n.4) without any principled basis and without support in the decisions of this Court or any other court interpreting the "profits" element of *Howey*. In addition, the common

understanding that the essential attributes of an investment contract are those of an equity security is consistent with the decisions of this Court, decisions of the lower federal courts, the state of the law at the time these provisions were enacted, SEC statements in a long standing interpretative release, and in commentary by the leading commentator in the field.

ARGUMENT

THE PAYPHONE LEASING ARRANGEMENTS WERE NOT "INVESTMENT CONTRACTS" AS LESSORS HAD NO EXPECTATION OF "PROFITS"

A. The term "investment contract" was used by Congress to denote a class of instruments having the economic characteristics of an equity security.

1. The focus of the federal securities acts was the protection of the broad capital markets. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). Congress took care to ensure the least possible interference from the government in legitimate business and "did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Reves v. Ernst & Young*, 494 U.S. 56, 61, 65 (1990) ("Congress was concerned with regulating the investment market, not with creating a general federal cause of action for fraud.") President Franklin D. Roosevelt wrote to Congress in 1933 that the purpose of the federal securities legislation should be the protection of the public "with the least possible interference to honest business." H.R. No. 73-85, at 2 (1933) *reprinted in* 1 Federal Securities Laws Legislative History 1933-1982, at 139 (1983). Congress determined that the best way to achieve the President's goal was to define the term "security" in terms sufficiently broad to cover the various

instruments that would develop in the commercial world and which would "'fall within the ordinary concept of a security.'" *Forman*, 421 U.S. at 848. (quoting H.R. No. 73-85, at 11 (1933)). Thus, in the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, Congress defined the term "security" by listing in its definition a number of specific instruments well known in the securities industry (such as stocks, bonds, and debentures), and a number of more general categories of instruments, including "investment contract" and "evidence of indebtedness." Pet. App. 30a.

While it is undefined in the statutes or legislative history, "investment contract," as one of the general categories listed under the definition of "security," *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 n.5 (1985), has been used by the Court to identify "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Id.* at 689 n.4. In assessing whether one of these "unusual instruments" was an investment contract, the Court has applied an economic reality test, for, if the Securities Acts were to apply in those cases at all, it would have to have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. *See id.* at 690. As the Court has stated, and as the SEC concedes (SEC Brief 18), by 1933, the meaning of "investment contract" had been crystallized by prior usage in the state courts to the extent that, in discerning what Congress meant when it used the term in the definition of "security," one could point to certain economic characteristics to determine if an instrument was an investment contract. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). Those characteristics had their genesis in the state "blue sky" law decisions and have guided seventy years of jurisprudential development by this Court and the lower

federal courts. Those characteristics are the essential attributes defining what is commonly understood to be an equity security: a share in the enterprise entitled to participate in the earnings of the enterprise or in the changing value of the enterprise's assets. In other words, an investor may expect a return that varies with the success of the business.

2. The first occasion the Court had to address the term investment contract was in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), where the defendant companies provided investors the opportunity to participate in an oil exploration enterprise by purchasing assignments of oil leases in a Texas oilfield. Without engaging in a detailed analysis or describing the criteria it was applying, the Court in *Joiner* concluded that Congress' intention in using the general designation of "investment contract" to denote a security brought within the definition the "[n]ovel, uncommon, or irregular devices" offered by the defendants as investments which had the prospect of appreciating in value if the exploration enterprise were successful. *Id.* at 351. Undeniably, the Court's decision that the investors had acquired investment contracts was rooted in the concept that the investors were expecting their investment of capital to appreciate in value if the promoter's drilling venture succeeded.

Three years later, in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Court again had occasion to examine a different type of unusual investment vehicle to determine if it fell within the definition of "investment contract." There, a promoter was offering small strips of land in a citrus grove coupled with a non-cancelable service contract whereby the promoter would use the extensive facilities of its established business enterprise to cultivate, harvest, and market the fruit from the several investors' adjoining, but otherwise not commercially usable, tracts, *id.* at 295,

and pay each investor his or her respective allocable share of the profits of the overall venture. *Id.* at 296. These profit shares would necessarily vary with the business performance of the enterprise and carried the risk that there might be no profits to share. The Court held that the land ownership documents coupled with the service contracts constituted investment contracts. *Howey*, 328 U.S. at 300. Unlike *Joiner*, the decision in *Howey* provided a detailed analysis of the history and meaning of the term "investment contract," noting that "emphasis was placed upon economic reality." *Id.* at 298. More significantly, in *Howey* the Court established, for federal law purposes, a three-part "test" for determining whether particular arrangements are investment contracts: there must be "an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301. The parties agree that the "*Howey* test" is the correct one to be applied here.

In determining Congress' intent as to the meaning of "investment contract," the Court looked to pre-1933 "blue sky" decisions. *Howey,* 328 U.S. at 298. The Court identified the decision in *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937 (Minn. 1920) as the seminal case defining the term. *Howey*, 328 U.S. at 298. In *Gopher Tire*, the Minnesota Supreme Court acknowledged that no prior case defined the term, and began its investment contract analysis by explaining that the word "investment" as commonly used meant "[t]he placing of capital or laying out of money in a way intended to secure income or profit *from its employment*. . . ." 177 N.W. at 938 (emphasis supplied). The analysis, however, did not end on this broad definitional note. Focusing on the essential attributes of the instrument involved–a certificate sold by a manufacturer of tires and tubes promising a share in the profits of the business–the court analogized it to "stock in that

[certificates] give their holders the right to share in the profits of the corporation, but their value is purely speculative, for their holders get no interest in the tangible assets of the corporation." *Gopher Tire*, 177 N.W. at 938. The certificates were found to fit within the scope of the term "investment contract" because the economic reality of the investment–or, more particularly, its investment risk–made it analogous to an equity interest in the enterprise: the investor expected to obtain a return amounting to a *pro rata* distribution of 20% of the manufacturer's net sales, as well as a bonus consisting of the excess earnings of the enterprise to be distributed, at the manufacture's option, in the form of preferred stock. *Id.* at 937-38. The SEC paints with too broad a stroke when it contends that *Gopher Tire*'s definition of "investment," "which includes both 'income' and 'profit,' is clearly *expansive enough* to include an investment having a fixed or contractually guaranteed return." SEC Brief 18 (emphasis supplied).[11] Such a position is unwarranted; it ignores both the facts deemed essential by the court in conducting its economic reality analysis and the context: the investor's interest was likened to a share of "stock"–the quintessential equity security–and the *source* of the investor's expected return

[11] Similarly, the SEC argues that the dictionary definitions of various root words comprising the statutory term "investment contract" show that it "easily accommodates an investment offering a fixed return. . . . " SEC Brief 17. Whatever these words may "accommodate" in isolation, Congress' use of the term in the statute must be considered against the legal usage of the term itself at the time and, more particularly, in light of the "context," as Congress prescribed. *See Weaver*, 455 U.S. at 556 ("The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires. . . .' ").

was a share in the enterprise's capital appreciation or its earnings.

The other pre-1933 state law cases identified by the Court in *Howey* also focused on various business arrangements where money was put at risk against the potential of a return in the form of a participation in the earnings of the enterprise or a share in expected capital appreciation.[12] An economic reality analysis showing that an investment was analogous to an equity security became the *sine qua*

[12] The state law cases cited by the Court, *Howey*, 328 U.S. at 298 n.4, that deal with investment contracts are readily categorized as involving investments offering a participation in earnings or a share of capital appreciation:

Participation in Earnings: *Moore v. Stella*, 127 P.2d 300 (Cal. Dist. Ct. App. 1942) (investors purchased certificates of interest in "mineral deeds" with right to participate in promoter's earnings or profits in the nature of oil royalties); *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill.App. 331 (Ill. App. Ct. 1930) (investors in installment land contracts entitled to have the "net profit" from the promoter's harvesting of crops on the land applied to the purchase price); *Stevens v. Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932) (investment in rabbit breeding enterprise with investor having right to receive $1 apiece for 50 percent of the offspring from the investor's breeding rabbits); *Cf. State v. Heath*, 153 S.E. 855 (N.C. 1930) (*no* investment contract where income was obtained from the investor's own effort and his money was not placed to secure income from its employment in the conduct of the business).

Capital Appreciation: *People v. White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) (investment agreement that after one year investor will receive payment from investment company amounting to his original principal plus earnings of specified amount based on the investment company's successful use of investor's funds); *State v. Evans*, 191 N.W. 425 (Minn. 1922) (fifty payment installment purchase of land with "option" which entitled investor to receive a cash "bonus" and return of purchase money upon surrender to promoter of the real estate). *Klatt v. Guaranteed Bond Co.*, 250 N.W. 825 (Wis. 1933), discussed the scope of the term "sale" in blue sky law (without reference to the term "investment contract") and thus is not included in either category.

non of the investment contract analysis and the requisite justification for invoking the remedial purposes of the blue sky laws.[13] The SEC erroneously contends that *People v. White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) and *Stevens v. Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932), two of the blue sky cases cited by the Court in *Howey,* illustrate that the "meaning of 'investment contract' involved fixed or contractually guaranteed returns." SEC Brief 18. As noted in the margin, *supra* page 19 n.12, the investors in those cases expected a return from the success of the promoters' use of money in the enterprise. The SEC confuses a true "fixed return," which is to be paid without regard to enterprise success, as in the lease agreements here, with instances where promoters give hypothetical (*Stevens v. Liberty Packing Corp.*) or stated (*People v. White*) amounts of expected returns from the earnings or appreciation of the enterprise. These latter types of returns are not "fixed" in an economic sense because any economic sharing of business success necessarily implies the *caveat: "if any."*

With respect to what constituted "profits," the *Howey* Court was specific; it stated that the investors' "respective *shares* in [the] enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable *shares* of the profits. . . . Thus all the elements of a profit-seeking

[13] The blue sky laws were aimed at "speculative schemes which have no more basis than so many feet of blue sky. . . . " *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917). The state courts interpreting the blue sky laws also recognized that those laws were not intended to police contracts where service is to be rendered or other obligations are incurred that do not involve either the recognition of capital appreciation or a participation in the profits of an enterprise. *See Creasy Corp. v. Enz Bros. Co.*, 187 N.W. 666 (Wis. 1922); *Lewis v. Creasey Corp.*, 248 S.W. 1046 (Ky. 1923); *State v. Heath*, 153 S.E. 855 (N.C. 1930).

business venture are present here. The investors provide the capital and *share* in the earnings and profits. . . ." *Howey*, 328 U.S. at 300, 301 (emphasis supplied). The repeated use of the word "share" in conjunction with the word "profit" cannot be said to be inadvertent. The Court thus identified an essential attribute of an investment contract as a return which would vary based on the success of the business.

Subsequent decisions by the Court reinforce the notion that investment contracts have specific attributes, like those identified in *Howey* and found in the early blue sky law cases. The thread running through all of the Court's cases confirms that investment contracts are analogous to, and have the essential attributes of, equity securities, including a return that varies with the success of the business of the common enterprise. In *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) ("*VALIC*"), the Court held that an instrument marketed by an insurance company as an annuity was not an insurance policy exempt from the federal securities laws. Rather, the instrument was held to be an investment contract with the investment risk being borne by the policyholder, who had paid premiums, a portion of which went into the insurer's investment fund. This meant that the "benefit payments vary with the success of the [insurer's] investment policy," and "may be greater or less, depending on the wisdom of [that] policy." *Id.* at 69-70. "The [policy] holder gets only a pro rata share of what the portfolio . . . reflects–which may be a lot, a little, or nothing." *Id.* at 71. Thereafter, in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), the Court looked again at insurance related products and held that an annuity contract could be considered a nonexempt investment contract during the contract's accumulation phase and an exempt insurance contract once contractually guaranteed fixed payouts began. Under the contract

at issue, the policyholder paid fixed monthly premiums which the issuer placed in a fund–called the "Flexible Fund"–invested by the issuer primarily in common stocks. At contract maturity, the policyholder could either withdraw the cash value of his proportionate share of the fund (which the issuer guaranteed would not fall below a specified value), or convert to a fixed-benefit annuity, with payment amounts determined by the cash value of the policy. During the accumulation phase, the fund from which the policyholder would ultimately receive benefits *fluctuated* in value according to the insurer's investment results; because the "insurer promises to serve as an investment agency and allow the policyholder to *share* in its investment experience," during this phase the policy was an investment contract. *Id.* at 208 (emphasis supplied). The SEC thus misconstrues the Court's holding when it claims that "*United Benefit* more specifically reinforces the conclusion that an investment contract may offer a fixed return. . . . " SEC Brief 12. As the Court noted, the SEC contended that only the separable variable return portion of the Flexible Fund was a security and "agreed" that the fixed payment portion was conventional insurance "beyond the purview of the SEC." *United Benefit*, 387 U.S. at 206.

The Court next addressed issues relating to the term "investment contract" in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). There, the Court held that a withdrawable capital share in an Illinois savings and loan association was a security. The Court reasoned that the shares "most closely resemble investment contracts," and that the test articulated in *Howey* was met. *Id.* at 338. The Court stated: "[t]he holders of withdrawable capital shares *are not entitled to a fixed rate of return*. Rather, they receive dividends . . . based on the association's profits." *Id.* at 337 (emphasis supplied). The Court noted that the share

purchasers were participants in a common enterprise dependent for its success upon the skill and efforts of the management with the shares representing an apportionment of profits, if any, from the success of the enterprise. The Court concluded: "[c]learly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) [of the Securities Exchange Act, 15 U.S.C. 78c(a)(10)] and as it was defined in *Howey*." *Id.* at 338-39. Although the opinion does not state so in as many words, the implication that follows from *Tcherepnin* is that a contract holder who is entitled to a fixed payment whether or not the obligor has current earnings and whose payment will not increase if the obligor has a successful year, does not, for purposes of the investment contract test, have a reasonable expectation of "profits."

The "essential attributes of investment contracts" identified by *Tcherepnin* formed the basis for analysis of the shares of "stock" in a co-op housing project alleged to be investment contracts in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The Court again referred to these "essential attributes" and observed that the "touchstone" of the *Howey* test is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *Forman*, 421 U.S. at 852. The Court then addressed the essential attribute of "profits" and provided a detailed statement of the characteristics of the "profits" element of the *Howey* test:

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in [*SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943)] (sale of oil leases conditioned on promoters' agreement to

> drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in Tcherepnin v. Knight, supra (dividends on the investment based on savings and loan association's profits).

Forman, 421 U.S. at 852. The context in which this passage appears, and the Court's ensuing analysis of the attributes of the "stock" to see if it carried an entitlement to *Howey*-type profits, suggest that the two enumerated categories of profits are exclusive.[14]

Next, the Court addressed the scope of the term investment contract in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979). The Court found a number of the essential attributes of an investment contract missing when considering whether a participant in a noncontributory, compulsory pension plan was an investor in an investment contract. Applying separately each part of the *Howey* test, the Court found that the expectation of profits element was not met because the benefits paid to a pensioner, assuming for purposes of the analysis they could be considered "profits," depended primarily on the employee's efforts to meet the restrictive vesting requirements of the pension fund, rather than the investment success of the investment fund comprised of the employer's contributions. *See id.* at 561-562. The Court also found "further evidence" that the types of pension plans involved were not subject to the Securities Acts based upon the enactment of ERISA, which provided

[14] The dissent in *Forman* expressed the understanding that the Court's definition of *Howey* "profits" was exclusive: the "Court must surprise knowledgeable economists with its proposition . . . that profits cannot assume forms other than appreciation of capital or participation in earnings." *Forman*, 421 U.S. at 863.

whatever disclosure benefits to employees they might derive from the effect of the Securities Acts. *Daniel*, 439 U.S. at 569-570.

In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the Court reviewed a decision which had applied the investment contract test of *Howey* to a certificate of deposit issued by a domestic bank. The Court held that it was not a security subject to claims under the securities laws' antifraud provisions. The Court distinguished the certificate of deposit from the withdrawable capital shares found to be investment contracts in *Tcherepnin*, stating: "[t]he withdrawable capital shares found [in *Tcherepnin*] to be securities did not pay a fixed rate of interest; instead, purchasers received dividends based on the association's profits." *Id.* at 557. Since the Court found the withdrawable capital shares in *Tcherepnin* to resemble most closely investment contracts, the implication that follows from the Court's language in *Marine Bank* is that the term "profits" as used in the investment contract test does not include fixed interest payments. *Marine Bank*, as had *Daniel*, noted the existence of a comprehensive set of federal regulations governing the instrument involved separate from the securities laws that made it unnecessary to subject them to securities law coverage as well. *Marine Bank*, 455 U.S. at 558-559. The Court expressly noted that Congress, in enacting the securities laws, did not intend to provide a federal remedy for all fraud. *Id.* at 556.

The Court next addressed application of the term "investment contract" in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) when it considered what had come to be known as the "sale of business" doctrine. In *Landreth*, the Court reiterated that the "*Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract'" and that the test was

not to be applied to determine if other listed types of securities were present. *Landreth Timber Co.*, 471 U.S. at 691. *Landreth* emphasizes the Court's position that the several descriptive terms used by Congress to describe a "security" were used to identify different types of securities having different characteristics, including those describing a "general category" of security, such as the term "investment contract."

Finally, in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Court returned again to questions involving the *Howey* test when determining whether or not demand promissory notes paying a fixed rate of interest, allegedly sold fraudulently by a farmer's cooperative, were "securities." The Court noted the broad sweep of the securities laws' definitions of "security," but twice reiterated that Congress did not intend to create a federal remedy for all fraud when it enacted the federal securities laws. *Id.* at 61, 65. The Court rejected the use of the *Howey* test to analyze whether the notes there were securities, and explained–as it had done in *Landreth*–that *Howey* provided a mechanism to determine if an instrument was an investment contract and was not "designed for an entirely different variety of instrument. . . . " *Id.* at 64. The Court "emphasize[d]" that the term "profit" it used in analyzing whether an instrument was a "note" was different from the way the Court had "defined 'profit'" for investment contract purposes. *See id.* at 68 n.4. Thus, if any doubt remained as to what was meant by "profits" in the investment contract context after *Tcherepnin, Forman* and *Marine Bank,* those doubts were put to rest by a unanimous Court in *Reves*. The Court was unmistakably precise as to its interpretation of the "profit" element of *Howey*: it had "defined 'profit' more restrictively in applying the *Howey* test to what are claimed to be 'investment contracts,'" to encompass only capital appreciation and a participation in

earnings. *Reves*, 494 U.S. at 68 n.4. The Court expressly "decline[d] to extend [*Howey's*] definition of 'profit' beyond the realm in which that definition applies." *Id.* The Court pointed out that the note category of securities, which was not subject to this "restrictive definition" of "profit," was not required to have a return on investment "keyed to the earning of the enterprise." *Id.* As the SEC correctly notes, SEC Brief 36-37, the Court did not purport to alter the meaning of "profits" from its use in *Howey*. Nor did the Court, contrary to the SEC's argument, SEC Brief 38, engage in a "mistaken" characterization of *Howey* or *Forman* when it explained why the *Howey* test was irrelevant to the analysis of "notes" as securities. This was not mere *dicta* as the SEC would have it. The SEC argues that one may participate in the earnings of an enterprise when that participation is not "measured" by the earnings. SEC Brief 36. The SEC concedes, as it must, however, that its position is directly contrary to the Court's unanimous position in *Reves*, yet it provides no principled reason why the Court should accept the SEC's claim that the Court was "mistaken." SEC Brief 37.

3. The SEC urges that the Court's observation in *Reves* of Congress' purposes for providing an expansive definition of "security"–to encompass virtually any instrument that might be sold as an investment (494 U.S. at 61)–should be given far broader reach than its import allows. Of course, all things that might be viewed as investments in common parlance are not securities, as the Court has noted, including, for example, "naked leasehold rights" (*Joiner,* 320 U.S. at 348); "fee simple interests in land" (*Howey*, 328 U.S. at 299); "a farm or orchard coupled with management services" (*id.*); the "hypothetical investment by the employee" in pension benefits (*Daniel*, 439 U.S. at 562); a bank certificate of deposit (*Marine*

Bank, 455 U.S. at 557-558); and a unique business agreement negotiated one-on-one between transacting parties (*id.* at 560). More to the point, of the instruments that might be sold as investments and *are* securities, all are not investment contracts, including, as the SEC concedes, categories of securities paying fixed returns, including "notes" and "evidence[s] of indebtedness." SEC Brief 42 n.15.

As the Court's decisions in these cases demonstrate, one defining characteristic of an investment contract is the investor's expectation of profiting from a separable financial interest that necessarily varies with the success of the enterprise, whether through market price appreciation of what is owned, as in *Joiner, VALIC* and *United Benefit*, or through an allocable share of the enterprise's earnings, as in *Howey* and *Tcherepnin*. This analysis is consistent with the pre-1933 blue sky cases and accurately reflects Congress' intent when it used the term "investment contract" in the definition of "security." In cases where the Court has concluded that the investment contract test did not supply the analytical framework for decision or where it did and the Court concluded that the instrument involved was not an investment contract, one of the factors noted by the Court was whether the return expected either varied with the success of the enterprise, as in *Reves* and *Marine Bank*, or whether the varying return that was dependent upon the efforts of others was a significant aspect of the investor's expected return, as in *Forman* and *Daniel*. Thus, the SEC is asking the Court to abandon sixty years of consistent jurisprudence and alter the well-established attributes of an investment contract to include characteristics from "an

entirely different variety of instrument." *Reves*, 494 U.S. at 64.[15]

4. The SEC urges that the remedial goals of the securities laws should lead the Court to conclude that investment contracts may include the essential attributes of both debt and equity securities, and that the fixed lease payments here are *Howey*-type profits. SEC Brief 19-21. But the statute is not structured that way, and these remedial goals "are insufficient justification for interpreting a specific provision more broadly than its language and the statutory scheme reasonably permit." *Pinter v. Dahl,* 486 U.S. 622, 653 (1988) (internal quotations omitted). The linchpin of the SEC's effort to convince the Court that the common understanding of the meaning of "profits" for investment contract purposes has resulted from too narrow an interpretation is the SEC's contention that the term investment contract is a "catch-all." SEC Brief 10, 16, 19, 20.[16] However, a statutory "catchall . . . operates as a safety net that Congress used to sweep up anything it had

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[15] The SEC's position ignores the basic tenet that "settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves*, 494 U.S. at 74 (Stevens, J., concurring) (further commenting that after a statute is construed by the Court or a course of other federal decisions "it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself").

[16] The support for its argument that the term investment contract is a "catchall" is *dicta* in *Golden v. Garafalo,* 678 F.2d 1139, 1144 (2d Cir. 1982). SEC Brief 19. In that sale of business doctrine case, the court used the term "catchall" without attribution or citation to any authority and nevertheless found the investment contract test inapplicable (as this Court later concluded in *Landreth*). Despite its unprecedented suggestion that "investment contract" was a "catchall," the court of appeals did not suggest that an investment contract could have a fixed return or that it did not have to have the economic characteristics identified by this Court's decisions.

forgotten to include in its definition." *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 587 (1995) (Thomas, J., Scalia, J., Ginsburg, J., and Breyer, J., dissenting). By arguing that the term investment contract is a "catchall," the SEC tacitly concedes that the facts here do not meet the well-established elements long recognized by this Court and the lower courts to determine the existence of an investment contract. And Congress did not "forget[ ] to include in its definition" instruments that do pay fixed returns, such as "notes, bonds, debentures," and the general category of fixed return instruments: an "evidence of indebtedness." See Pet. App. 30a.[17] The SEC notes that Congress included these investments paying a fixed return in the definition of security. SEC Brief 19. The conclusion the SEC draws from that–"it makes sense that the catch-all term 'investment contract' should also include such investments" (*Id.*)–is a non-sequitur and ignores the rule of statutory construction that "the Court will avoid a reading which renders some words altogether redundant." *Gustafson*, 513 U.S. at 574.

It is noteworthy that from among the many federal court decisions construing the term investment contract, the SEC is able to cite only an isolated, equivocal, *dicta* comment from one case to support its contention that the

[17] As noted in the dissenting opinion in *Gustafson*, the Securities Act definition of "security" does include what can be deemed a "catchall" term: " . . . or, in general, any interest or instrument commonly known as a 'security' . . . " 513 U.S. at 587 (quoting 15 U.S.C. § 77b(a)(1)). In *Forman*, the Court "for present purposes" noted that it perceived no distinction between the scope of "investment contract" and the statutory catchall. 421 U.S. 852. The Securities Exchange Act has a similar provision: " . . . or in general, any instrument commonly known as a 'security' . . . " (15 U.S.C. § 78c(a)(10)). Pet. App. 30a.

Howey investment contract test applies to equity *and* debt instruments. SEC Brief 20, citing *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (the statutory definition "suggests" that the term "investment contract" has the essential properties of a debt or equity security). It is significant that Professor Louis Loss, long recognized by the Court as a leading commentator on the federal securities laws, disagrees. Professor Loss, when discussing *Reves* in his treatise on the securities laws, stated that the Court was "clearly correct" in holding that the "equity" test announced in *Howey* "should not be applied to a debt instrument." 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 951 (3d ed. 1999). It cannot be denied that the SEC is inviting the Court to determine for the first time, and with no direct precedent from the lower courts, that the term investment contract is a "catchall" term broad enough to "catch" lease instruments merely because they have one characteristic in common with certain defined types of debt securities, and even though that characteristic has not heretofore been associated with investment contracts. This is not the first time the SEC has argued to the Court that a fixed payment not derived from capital appreciation or a participation in earnings is a *Howey*-type profit; this same position was advanced by the SEC in its *amicus* brief in *Reves*. See Brief for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480). The Court unanimously and explicitly announced a contrary view. Nothing in the law has changed to suggest that the SEC is any more correct in this position now than it was then. On several other occasions, this Court has rejected the SEC's efforts to extend the realm of *Howey* to instruments that do not have all of the commonly understood characteristics of an investment contract. *See, e.g.*, *Daniel*, 439 U.S. at 566 n.20 (1979) (citing cases). The

same result should obtain here. As noted at page 1, *supra*, ETS's leasing arrangements are regulated under the FTC's business opportunity regulations and are subject to the FTC's enforcement powers. Under similar circumstances, the Court has refused to extend the reach of the securities laws to cover instruments it concluded were adequately regulated under other federal statutory schemes. See pages 24-25, *supra*.

5. In seeking to extend the definition of "profits," the SEC points to the literal meaning of "guaranty," "invest," "income," "contract," and "profit." SEC Brief 14, 17, 18, 36. An examination of economic realities, not dictionary definitions, should be used to identify what is or is not an investment contract. *Forman*, 421 U.S. at 849. The economic realities presented by the record here show that lessors parted with their money to acquire a pay telephone to use for commercial purposes and then they entered into a lease agreement providing for a fixed monthly payment, an expense which ETS could pay from many sources (not "keyed" to ETS's or the pay telephone's earnings) such as revenues, borrowings, asset sales, payments from a subsidiary, or otherwise. Earnings of the business would be available only after its expenses were paid and would go only to ETS. No lessor received any share in ETS's profits or expected capital appreciation from ETS. The apparent difficulty of finding a profit expectation in lessors when the transaction is analyzed in light of "the content of the instruments in question, the purpose intended to be served, and the factual setting as a whole," *Marine Bank*, 455 U.S. 561 n.11, has led the SEC to look to isolated words or phrases in the marketing materials used by the independent distributors and by ETS for proof that a lessor could reasonably expect *Howey*-type profits from the lease arrangement. SEC Brief 4, 12, 25, 27. As noted at

page 3, *supra*, the materials included several options for a telephone owner to commercialize the telephone, including options allowing the owner to directly obtain the earnings of the telephone. Nothing in the materials describing the lease option suggests that a *lessor* could earn a "profit." J.A. 128-130. Certain of the materials referred to by the SEC in this regard were directed by ETS to potential site owners, not telephone owners. SEC Brief 4; J.A. 48, 111-121, 168. Site owners did participate in the profits from the telephones placed on their property. J.A. 177. The SEC is incorrect in contending that *lessors* were told they were able to share in any "profits." SEC Brief 12, 25, 27. Unlike the situation in *Joiner*, 320 U.S. at 353, where the promoter's offerings completely changed the tenor of what was being acquired, here, the lease presentations and instruments leave no room for doubt as to the substance, not just the name affixed to the transaction. No reasonable lessor could have believed he was acquiring a share in ETS's earnings or an opportunity for capital appreciation by his lease. The terminology "lease" was neither a misnomer nor misleading. The names of instruments used by the parties may be relevant to the determination of their status as securities. Here, no lessor was led by ETS "justifiably to assume that the federal securities laws apply." *Forman*, 421 U.S. at 850. That other options for commercialization of pay telephones were discussed in the ETS materials and were available to pay telephone owners does not alter the essential attributes of the instruments involved here.

6. While it is appropriate to consider each of the three *Howey* elements separately, *Daniel*, 439 U.S. at 559, they cannot be considered in isolation. Therefore, while it makes no difference from an analytical standpoint whether the lessors are viewed as parting with their money to buy a telephone or with their telephone to obtain

a lease agreement, *see, e.g., Daniel*, 439 U.S. at 560 n.12, the only arguable "common enterprise" in this case is the lease arrangement between each lessor and ETS, for that bargain is the only source of alleged "profit" payments.[18] Thus, even if the telephone purchasing and leasing transaction by the lessors could be viewed as a "package," as the SEC contends, SEC Brief 3, 9, 13, the economic inducement is unchanged–it remains a fixed monthly lease payment.

After holding that ETS's lease payments were not *Howey*-type profits, the court of appeals observed that, in any event, the final element of the *Howey* test was not satisfied by the SEC because the payments the lessors expected would not be "derived solely from the efforts of others." Pet. App. 7a. According to the court of appeals, "the determining factor [was] the fact that the investors were entitled to their lease payments under their contracts with ETS" and the returns were "derived as the benefit of the investors' bargain under the contract." *Id.* The SEC attacks this conclusion as grounded in "[n]either logic nor precedent." SEC Brief 38. The SEC is in error.

[18] The nature of the common enterprise element is important because a lease arrangement, at most, exhibits only "vertical commonality" between ETS and the individual lessors. Respondent has maintained that "horizontal commonality" is the proper test to determine the existence of a common enterprise under *Howey*, but that neither commonality test was met. As the court of appeals noted, there is a sharp split among the circuits regarding the proper test for determining the presence of a "common enterprise." Pet. App. 5a-6a, 9a-15a (Lay, J. concurring); *see also Mordaunt v. Incomco*, 469 U.S. 1115 (1985) (dissent from the denial of a petition for certiorari). Application of the horizontal commonality test would also result in dismissal of the case for lack of subject matter jurisdiction. *See* Pet. App. 13a-15a (Lay, J., concurring).

Both logic and precedent support the conclusion of the court of appeals that the lessors were not dependent upon ETS's success in managing the common enterprise in order to obtain what they were entitled to in their lease arrangement. The lessors stood to recover no more nor less than the lease payments, and ETS's efforts, or lack of them, could not change that amount or alter the lessors' rights under the agreement. In short, they were not looking to ETS to add value to what they already owned at the inception of the relationship–a right to either fixed lease payments or to have their telephone back–and they did not face any investment risk affecting the value of the business arrangement with ETS. *See Guidry v. Bank of La Place*, 954 F.2d 278, 284 (5th Cir. 1992) (to be investment contract, arrangement must contemplate, at the outset, some risk that investor can lose investment or that value of his return can fluctuate). Therefore, the lessors could not "profit" in the investment contract sense from the efforts of ETS.[19]

[19] The Court should not entertain the SEC's contention that the court of appeals should have *sua sponte* remanded this case to the district court to consider whether the instruments here were "notes" or other "evidence[s] of indebtedness." SEC Brief 42 n.15. The SEC made no showing whatsoever from which the court of appeals could conclude the SEC had a " 'reasonable probability of ultimate success' " on this issue. Pet. App. 4a. The SEC has not, and cannot, point to anything issued by ETS that constitutes a "note"; the lease agreements are not notes nor are they an "evidence of indebtedness" any more than any other executory contract. The SEC's complaint expressly alleged that the "investments [by the lessors] are investment contracts *and therefore are securities*." J.A. 6 (emphasis supplied). No other type of security was mentioned in the complaint. Moreover, neither the district court nor the court of appeals entertained this contention. It should not be considered here. See page 10 n.10, *supra*. *Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981), *cert. denied*, 455 U.S. 939 (1982) does not require a remand to the district court. Unlike this case, the defendants in *Meason*

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B. The courts of appeals have concluded that fixed payments do not meet the *Howey* "profits" test.

1. Four courts of appeals, in addition to the court below, have concluded that the "profits" element of *Howey* is not met by a fixed payment that is not derived from capital appreciation or a share of company earnings. In all of these cases, there were contractual arrangements involving the payment of money where one party was relying upon another party's performance, but none of these cases satisfied the expectation of profits from the efforts of others test. *See Resolution Trust Corp. v. Stone,* 998 F.2d 1534 (10th Cir. 1993); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981). *See also Lavery v. Kearns*, 792 F. Supp. 847, 853 (D. Me. 1992) (fixed returns do not equal profits because fixed payments mean that it is contractually impossible for the payee to be sharing in the profits or losses with anyone). The SEC first attempts to distinguish this line of authority by contending that the cases involve "loan participations" and not sales to "ordinary investors," and then it simply dismisses the decisions as "mistaken[ ]." SEC Brief 30 n.11. None of the cases suggested that the profits issue turned on the nature of the transaction as a loan participation or the nature of the investor as not "ordinary." Nor have any decisions of the

made a *facial* attack on federal jurisdiction, thus remand was appropriate. *Id.* at 551.

Court suggested that an instrument's classification as an investment contract was dependent upon whether the purchaser was an "ordinary investor."[20] The SEC provides no principled reason why the Court should analyze the "profit" issue on such a basis or why these courts of appeals were mistaken.

2. Since the federal securities laws were enacted, the "profits" that have led the lower federal courts to find an investment contract present have been the variable, equity-type returns discussed above. This is true for cases decided before *Howey*, including those federal cases *Howey* referred to as consistent with the test it fashioned, *Howey*, 328 U.S. at 299 n.5.,[21] and those post-*Howey* cases identified

[20] The federal securities laws historically have been applied to all types of investors. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (explaining that the "speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders").

[21] *SEC v. Crude Oil Corp.*, 93 F.2d 844 (7th Cir. 1937) (sale of oil delivery contracts with distribution of proceeds of oil sales at increasing prices for 25 years); *Penfield Co. of California v. SEC*, 143 F.2d 746 (9th Cir. 1944), *cert. denied*, 323 U.S. 768 (1944) (variable pro-rata sharing in the net proceeds of a bottling business); *Atherton v. United States*, 128 F.2d 463 (9th Cir. 1942) (purchasers of leased acreages to oil well and drill site to receive pro-rata share of final sale of entire acreage upon completion of oil well); *SEC v. Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940) (contributors to receive 30% profit per year from profits of farming operations); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) (sale of small tracts for cultivation of tung trees by large development company with income from sale of tung oil and capital appreciation in value of tract from development of land); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (pro-rata sharing in the profits from breeding and selling the offspring of silver foxes); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D. Ky. 1942) (sharing in the profits of a whiskey bottling and selling plan); *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935) (sharing of earnings with

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by the SEC in its brief to the Court, SEC Br. 23 n.9, almost without exception.[22] The SEC discusses only two cases decided over the past 57 years to support its argument that the courts of appeals have specifically recognized fixed returns as meeting the "profits" element of *Howey*, *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001) and *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978). SEC Brief 27-30. While those cases did refer to the return on investment as "fixed," both courts were addressing the "common enterprise" element of *Howey* and not the "profits from the efforts of others" element; moreover, the statement by those courts that the return was "fixed" does not call into question the correctness of the Court's formulation of what constitutes "profits" for investment contract purposes.[23]

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promoter resulting from speculative grain and stock market contracts); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939) (pooling of investor installment payments in trusts to purchase bank stock with expectation of profits from dividends and market appreciation of stock); and *SEC v. Pyne*, 33 F. Supp. 988 (D. Mass. 1940) (sale of shares in fishing boats with the right to share in the profits of the business).

[22] *Capital Appreciation: United States v. Jones*, 712 F.2d 1316 (9th Cir. 1983), *cert. denied*, 464 U.S. 986 (1983); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027 (2d Cir. 1974); *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971); and *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968). *Participation in Earnings: Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918 (4th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989); *Albanese v. Florida Nat'l Bank*, 823 F.2d 408 (11th Cir. 1987); and *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954).

[23] Both *Carman* and *Infinity Group* relied upon *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974), a pre-*Forman* case, as precedent that a "fixed return" is a *Howey*-type profit. In *El Khadem* the court concluded that the tax

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Although *Forman* was at the time the Court's most recent relevant decision on the meaning of the statutory term "investment contract," *Carman* did not even mention *Forman* in its investment contract analysis. *Carman*'s focus was not on the "profits" element of the *Howey* test; it sought to determine if a common enterprise was present in a business arrangement where financial institutions (not "ordinary investors," SEC Brief 30 n.11) acquired bundled Federally Insured Student Loan notes and a service agreement providing for repurchase by the promoter of any defaulted notes. The court concluded there was a common enterprise meeting the court's "vertical commonality" criteria because the success of both promoter and investor were dependent upon the promoter's continued solvency despite the "fixed" return on the notes. *Carman*, 577 F.2d at 563. *Carman* does not lend any meaningful support to the SEC's argument for an extension of the "profits" aspect of the *Howey* test. Subsequent Ninth Circuit decisions have cited the language from *Carman* relied upon by the SEC, but only with reference to the common enterprise element of the *Howey* test. *See SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994); *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985); and *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978). Two years after *Carman*, the same court, in *Noa v. Key Futures, Inc.*, 638 F.2d 77, 80

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benefits derived from paying fixed interest on a promissory note was a "profit" that met the *Howey* test. *Id.* at 1229. That notion was fully discredited by the Court in *Forman*, 421 U.S. at 855 n.20, and *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986) (payment of interest with consequent deductibility for tax purposes not income or profits, citing *Forman*). In any event, the court in *El Khadem* expressly stated that its holding did not apply to situations where the purchaser's collateral could be redeemed, as here. *El Khadem*, 494 F.2d at 1230 n.14.

(9th Cir. 1980), established that the risk of insolvency alone is insufficient to establish the requisite dependency for a common enterprise. *See SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986) (also citing *Noa* and noting that the greatest risk to the purchaser was the failure of the enterprise, but that this was insufficient to meet *Howey* because of its ready applicability to any sale-of-goods contract).

Likewise, in *SEC v. Infinity Group,* the third element of the *Howey* test was not at issue. The defendants *agreed* that the instruments involved, called "property transfer contracts," satisfied the "profits solely from the efforts of others" element of the *Howey* test. 212 F.3d at 187. After a cursory review of the "efforts of others" question that did not mention *Forman* or analyze the issue of "profits," the court agreed that the third element was met. *Id.* The "focus [of the courts'] analysis [was] upon the 'common enterprise,' or second prong, of the *Howey* test." *Id.* at 187. The court rejected the defendants' claim that a fixed rate of return defeated horizontal commonality because investors would not share *pro rata* in any "profit" as described by *Forman*. *Id.* at 188-189. The court noted that the "definition of security" does not turn on whether the investor's "rate of return" is fixed or variable. *Id.* at 189 (citing *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir. 1974)). (See discussion of *El Khadem* at page 38 n.24, *supra.*) While the SEC points to the promoter's "guaranteed . . . rate of return," SEC Brief 28, as a "fixed" return equivalent to the lease payments here, the guarantee was of no moment to the decision as the court found the "guarantee" illusory, and concluded that "the investors here were guaranteed nothing . . . ." *Id.* at 190. Concerned that it would create a "loophole" by accepting an argument whereby "a gossamer guarantee of

seemingly impossibly high returns at no risk" would be a "fixed rate of return," thereby defeating horizontal commonality, the court found the promoter's illusory "guarantee" irrelevant to the analysis. *Id.* at 191. The SEC's argument appears to suggest that the court's comment regarding "variable or fixed rate of return," *id.* at 189, applies to the *Howey* "profits" element. SEC Brief 28. The court's discussion, while not a paragon of clarity, undeniably is directed to the "common enterprise" element of *Howey*.

The SEC's further claim to *sub silentio* support from other courts of appeals is not only a slender reed, but also is in error. SEC Brief 29. In *SEC v. S.G. Ltd.*, 265 F.3d 42 (1st Cir. 2001), investors were enlisted to play a cyberspace "stock exchange" game, paying for shares in fictitious companies, including one the promoters "boasted" would have a ten percent average monthly increase, but "conceded that a decline in the share price was theoretically possible. . . . " *Id.* at 44-45. The cyberspace "investors" were looking for market price appreciation of their shares, and its admittedly fluctuating value shows that the shares did not entitle the owner to a fixed payment, such as a lease payment. The SEC simply misreads *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), *cert. denied*, 498 U.S. 1025 (1991). SEC Brief 29-30. There, the court of appeals found that the sale of certificates of deposit in a "CD Program" satisfied the profits element of the *Howey* test because the CD program had, *inter alia*, "the potential for price appreciation due to interest rate fluctuations. . . . " *Id.* at 240. These were not, as the SEC suggests, simply "certificates of deposit paying fixed rates. . . . " SEC Brief 30. *SEC v. Professional Associates*, 731 F.2d 349 (6th Cir. 1984), a pre-*Reves* case, involved

the issuance of a promissory note with respect to an escrow account fund and an interest in trusts of commingled investor funds, one of which was said to "promise[ ] 9% annually." *Id.* at 355. Not only did the court not address the *Howey* "profits" element of the "escrow fund" and trust accounts, the court noted that the defendants conceded the "profits" element of the investment contract test as to the trusts. *Id.* at 354. *SEC v. Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940) fares no better as authority that fixed payments may be profits. In that case, the promoter agreed that after five years members of his "plenocracy" were entitled to receive a return amounting to 30% annually of the profits of the common enterprise, which was engaged in agricultural operations. *Id.* at 235, 237. The entitlement to a return of 30% *from profits* of the enterprise is entirely consistent with this Court's teachings (in *Howey* the representation was of an *expected* 10% annual return, 328 U.S. at 296) and does not represent a "fixed" payment akin to the lease payments here. Implicit in the "30% from profits" promise is the common sense notion that if the profits are less than 30 percent, or there are no profits, the member would receive less or nothing. The *Universal Service Ass'n* opinion does not support the SEC's position. Finally, the SEC's reliance upon *SEC v. Better Life Club of Am.*, 995 F. Supp. 167 (D.D.C. 1998), *aff'd*, 203 F.3d 54 (D.C. Cir. 1999) (Table), *cert. denied*, 528 U.S. 867 (1999) is surprising for several reasons. First, the district court analyzed the promissory notes sold to investors to see if they met the *Howey* test, relying upon *Baurer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981), which had specifically been rejected by the Court eight years earlier in *Reves*, 494 U.S. at 64. *Better Life Club*, 995 F. Supp. at 173. Second, the promised doubling of investment money was to come from the profits generated by a pooled fund

of invested money–"investment payouts disguised beneath the façade of promissory notes." *Id.* at 174.

In its analyses of these cases, and throughout its brief, see page 20, *supra*, the SEC confuses the issue by trying to equate ETS's fixed lease payments with the promise or "guarantee" of payments from what are actually participations in the varying earnings of a common enterprise. As the SEC would have it, every expected return is a "fixed return" because it can always be reduced to a percentage.[24] The economic characteristic of the payment does not change from a participation in earnings merely because a boastful "rate of return" claim is promised by the promoter. In fact, the courts often view that false promise of performance as a key fraudulent representation. Whether they call them variable or fixed, or even bother to characterize them at all, these lower courts have described, almost without exception, the amounts to be received by the investor in terms that reflect a payout based upon either capital appreciation or earnings from the use of the investor's funds. In sum, there has been a consistent course of federal decisions adhering to a construction of "profits" for *Howey* test purposes that compels the conclusion that investment contracts are equity securities.

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[24] While the SEC has provided an extensive list of cases, SEC Brief 41 n.14, to prove that it polices instruments providing fixed returns under the "investment contract" rubric, we note that the "fixed return" description of many, if not most, of those cases appears to suffer from the same confusion noted in the text.

C. The policy considerations and past interpretations posited by the SEC do not warrant abandonment of the common understanding of the contours of the *Howey* "profits" test.

1. Both the SEC and certain *amici* complain that a refusal to expand the scope of the term investment contract to encompass attributes traditionally associated with non-equity securities will create a "loophole" in their respective regulatory jurisdictions and bar private actions under the securities laws for conduct involving lease instruments or others paying a fixed return. *See, e.g.*, SEC Brief 40-42. That argument, however, should be directed to Congress, as it cannot fairly be said that the courts "open a loophole" when they rule that the statute does not reach certain conduct. Indeed, such an argument could be made anytime the courts determine that certain activity is beyond the reach of some agency's regulatory mandate, even though, as here, it is within the statutory mandate of another.

2. The SEC urges that deference should be paid to its "longstanding view . . . that an investment contract encompasses an arrangement paying a fixed or contractually guaranteed return." SEC Brief 31. That longstanding view is said to be reflected in the agency's litigation position in various enforcement cases, SEC Brief 31, in *amicus curiae* briefs and in interpretations, SEC Brief 32, and in "two formal adjudications." SEC Brief 33. Of course, before a court considers an agency's construction of a statute that it is charged with enforcing, the Court must conclude that there is an ambiguity in the language Congress has used. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). The SEC has not questioned that *Howey* correctly assessed Congress' intent when it used the term "investment contract." Thus, there is no statutory ambiguity in that regard.

There is only what the SEC contends is an ambiguity or error in the Court's explanation of the elements of *Howey*, including the "profits" element. With the Court's decisions in *Forman* and *Reves*, the first step of the *Chevron* test is not met; there is no statutory ambiguity to resolve on the "profits" issue, and this Court should adhere to its earlier decisions. *Neal v. United States*, 516 U.S. 284 (1996) (once the Court has determined a statute's meaning and in the absence of intervening statutory changes casting doubt upon the Court's interpretations, *stare decisis* dictates the earlier decisions be upheld against any later agency interpretations); *Natural Res. Def. Council, Inc. v. Nuclear Regulatory Comm'n*, 216 F.3d 1180, 1185 n.11 (D.C. Cir. 2000) (citing *Maislin Indus. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) for the proposition that the customary deference under *Chevron* does not apply when the Supreme Court has already determined the meaning of a term in a statute).

However, even if ambiguity exists and the Court proceeds to examine the SEC interpretations of the "profits" element of the *Howey* test, the SEC should not receive deference here. *See United States v. Mead Corp.*, 533 U.S. 218 (2001).[25] There are no detailed, reasoned, and longstanding formal SEC positions supporting its claims. Rather, the SEC's interpretations are inconclusive and hardly representative of an official agency position that fixed rental payments under a lease arrangement are incorporated within the judicial and administrative

[25] Even if the pre-*Chevron* doctrine of *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944) is applicable, which permits an agency's interpretation to be given some weight due to the agency's expertise, familiarity, and its power to persuade, no weight is due the SEC's view here for the reasons given in the text.

understanding of "profits" for investment contract purposes. As noted by the Court in *Daniel*, 439 U.S. 551, 566 n.20, and in subsequent decisions, *Pinter v. Dahl*, 486 U.S. at 653 n.27, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175-176 (1994), and *Aaron v. SEC*, 446 U.S. 680, 693-694 (1980), the Court has frequently rejected the SEC's interpretations of various provisions of the federal securities acts. The SEC also concedes it unsuccessfully advanced the same position it takes here in its *amicus curiae* brief in *Reves*. SEC Brief 32. *See Reves*, 494 U.S. at 68 n.4. While the Court has given varying reasons for rejecting the SEC's views in these cases, ultimately the agency's inconsistent approach to an issue or an interpretation at odds with the language, purpose and history of the statute's application constrains the usual deference. *Daniel*, 439 U.S. at 566 n.20.

The SEC's interpretations made for purposes of litigation, such as in pleadings to a court, consent decrees, or as interpretive guidance should be viewed cautiously unless they are supported by regulations, rulings or administrative practice. *See generally Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988) (explaining that deference to "what appears to be nothing more than an agency's convenient litigating position" is inappropriate). Such positions do not carry the force of law, irrespective of whether the interpretive material was promulgated in the exercise of the agency's authority. An enforcement case cited by the SEC, *SEC v. Amtel Communications, Inc.*, Lit. Release No. 14713, 60 S.E.C. Dkt. 1753 (Nov. 7, 1995), is one example. SEC Brief 31-32. *Amtel* resulted in the denial of the SEC's motion for preliminary injunction and, after the denial, the SEC amended its complaint and the case settled. *SEC v. Amtel Communications*, No. 95-CV-1127 (S.D. Cal. filed July 17, 1995). Another case relied on by the SEC to show its longstanding litigation position,

SEC Brief 31, *SEC v. Universal Service Ass'n*, 106 F.2d 232, discussed at page 42, *supra*, does not show a consistent agency position that fixed returns can be "profits" for investment contract purposes as the returns there were not fixed, just capped. The SEC interpretive guidance set forth in *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, Securities Act Release No. 33,3892, Fed. Sec. L. Rep. (CCH) ¶ 2755 (Jan. 31, 1958) and *Multi-level Distributorships and Pyramid Sales Plans*, Securities Act Release No. 33,5211, Fed. Sec. L. Rep. (CCH) ¶1048 (Dec. 7, 1971) are likewise, not helpful and not official positions relevant to this issue. The leasing operations of ETS did not entail any of the sales plans–all classic participation in common enterprise earnings arrangements–described in Securities Act Release No. 33,5211. The SEC relies upon this release for its statement that, in an investment contract, "the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise." SEC Brief 32. The quoted passage continues, however, by explaining that "*Howey* described an investment contract providing the investor with an *equity interest* in the common enterprise; where the interest offered is of a different nature the promised return *will necessarily vary*. Thus, for example, *market-price appreciation in value–not profits in a commercial sense*–was significant in the investment contracts recognized by the Supreme Court" in *VALIC* and *United Benefit. Multi-level Distributorships*, Securities Act Release No. 33,5211, Fed. Sec. L. Rep. (CCH) ¶1048 (emphasis supplied). "Market-price appreciation"–another way of saying "capital appreciation"–also represents an equitable interest in the common enterprise. The SEC position in the interpretative release is inconsistent with its position here and makes Respondent's point: a participation in earnings

or capital appreciation are the hallmarks of an equity security and denote "profits" for investment contract purposes.

In re Abbett, Sommer & Co., Exchange Act Release No. 34,8741, 44 S.E.C. 104 (Nov. 10, 1969), which relied on *Los Angeles Trust Deed & Mortg. Exchange v. Securities and Exchange Commission*, 285 F.2d 162 (9th Cir. 1960), *cert. denied,* 366 U.S. 919 (1961), for its explanation of "profits," does not, as the SEC asserts, SEC Brief 33, present a statement of agency views on the matters before the Court. In *Abbett*, the SEC admittedly departed from the existing line of investment contract cases where the promoter's services "were designed to create a profit" and concluded that the services "were directed essentially toward minimizing the risk involved in the investment." *Abbett*, Exchange Act Release No. 34,8741, 44 S.E.C. 104. The minimizing of the risk of an investment–even if it could be "liquidated into cash," *Forman*, 421 U.S. at 855–is a far cry from a fixed lease payment; indeed, the value of the reduction of the risk of an investment, even if a "profit" under *Howey*, would be a variable, highly dependent upon circumstances. Securities Act Release No. 33,3892, *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, is to the same effect as *Abbett* and does not manifest anything other than what is a quintessential capital appreciation (or avoidance of loss) arrangement.[26] These cases and

[26] In *In re Union Home Loans*, Exchange Act Release No. 34,19346, 26 S.E.C. Dkt. 1346 (Dec. 16, 1982), the parties settled the case without admitting or denying the facts as set forth in the report and order. The case was not litigated, does not include a reasoned opinion and therefore is not a formal adjudication entitled to deference, as the agency's

(Continued on following page)

releases are not persuasive and are not entitled to deference.

The SEC's reliance upon *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965), a bankruptcy case, is misplaced. In the opinion, the Court described a trailer leasing business that had filed a petition under Chapter 11 of the former Bankruptcy Act, 11 U.S.C. § 701, *et seq.* (1958 ed.). It is apparent from the face of the decision that the promoters did not contest the SEC's position that the lease arrangements were investment contracts. *Id.* at 598-599. Moreover, to the extent that the sale and leaseback scenario in *SEC v. American Trailer Rentals Co.* could be said to represent the agency's view that such businesses engaged in the sale of investment contracts, that view was not consistently followed when the SEC was made aware in 1995 of the structure of Respondent's pay telephone leasing business, including the redesigned corporate structure to assure compliance with the federal securities laws.[27]

own precedents show. *See In re Shipley*, Exchange Act Release No. 34,10870, 4 S.E.C. Dkt. 476 (June 21, 1974) (isolated SEC order in non-litigated case "is of no general import"). Moreover, *Union Home Loans* did not reference the profits component of the *Howey* test.

[27] In *SEC v. American Trailer Rentals Co.*, 379 U.S. at 612-13, the Court rejected the SEC's interpretation of the Bankruptcy Act because the Court could find no support in either the language of the statute or its legislative history for the SEC's position.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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In the Supreme Court of the United States

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v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

The court of appeals dismissed the complaint of the Securities and Exchange Commission (SEC) based on the erroneous conclusion that an investment is not an "investment contract" if it offers a fixed or contractually guaranteed return. Respondent fails in his efforts to reconcile that limitation with the text and purposes of the securities laws, the broad and flexible construction of "investment contract" repeatedly applied by this Court, and the SEC's longstanding interpretation. The most notable aspect of respondent's brief, however, is what it does *not* say. Respondent identifies no basis in the statutory text for distinguishing between fixed- and variable-return investments. He also offers no reason why Congress would have wanted to draw that distinction, and he does not attempt to square it with the purpose of the securities laws to protect purchasers of both fixed- and variable-return investments. In fact, the rule adopted by the court of appeals would create a serious gap in the protection provided by those laws be-

cause it would allow unscrupulous promoters to circumvent them merely by limiting the returns offered by their investment schemes to fixed or contractually guaranteed amounts, even though that limitation has no relationship to the need for the laws' protection.[1]

A. The Statutory Text And Purposes Demonstrate That An "Investment Contract" May Have A Fixed Or Contractually Guaranteed Return

Respondent acknowledges that the definition of "security" is broad and encompasses not only "stocks, bonds, and debentures" but also "more general categories of instruments, including 'investment contract.'" Br. 15. He also acknowledges that Congress included that "more general" term in order to cover "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Ibid.* (quoting *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 690 n.4 (1985)). And respondent does not dispute (Br. 18 n.11, 32) that the ordinary meaning of the term "investment contract" includes arrangements offering fixed or contractually guaranteed returns. See SEC Br. 17. He nonetheless argues that an "investment contract" is restricted to investments with variable returns. Indeed, he contends that an investment contract is limited to a *particular type* of variable-return investment—one with what he terms "the essential attributes" of "equity securities," specifically, "a return that varies with the success of the business of the common enterprise." Resp. Br. 21. That contention cannot be reconciled with the text or purposes of the securities laws.

1. Because the ordinary meaning of the statutory language does not support him, respondent seeks to ground his argument in this Court's conclusion in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), that Congress intended "investment contract" to have the same meaning in the federal securities laws as in the state Blue Sky Laws that predated them. Respondent argues (Br. 17-20) that pre-1933 cases interpreting the Blue Sky Laws limited the term "investment contract" to arrangements with a return that varied with the success of the overall enterprise. But, as the SEC's opening brief (at 18-19) demonstrates, the Blue Sky cases did *not* limit "investment contract" in that manner. On the contrary, "investment contract" had been "broadly construed by state courts so as to afford the investing public a full measure of protection." *Howey*, 328 U.S. at 298. That construction—which included any "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment'"—encompassed investments with fixed returns and returns to which investors were contractually entitled. *Ibid.* (quoting *State* v. *Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn.

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[1] Respondent errs in contending (Br. 8-9 n.8) that the Court need not accept the allegations of the complaint. In *Saudi Arabia* v. *Nelson*, 507 U.S. 349 (1993), the Court identified the motion at issue as one "to dismiss the complaint" (*id.* at 351) "for lack of subject matter jurisdiction" (*id.* at 354) and ruled that the Court was required to assume the truth of the allegations. *Id.* at 351. Moreover, the court of appeals' decision here turned on its conclusion that the payphone arrangement did not involve a "security" and consequently there was no cause of action under the securities laws. Respondent's own cases confirm that, when an "attack on subject matter jurisdiction also implicates an element of the cause of action," the challenge is treated as an attack on the merits, and "the defendant is forced to proceed under Rule 12(b)(6)" (with the allegations of the complaint taken as true) unless the claim is "clearly immaterial or insubstantial." *Garcia* v. *Copenhaver, Bell & Assoc., M.D.'s, P.A.*, 104 F.3d 1256, 1261 (11th Cir. 1997) (quoting *Williamson* v. *Tucker*, 645 F.2d 404, 415-416 (5th Cir.), cert. denied, 454 U.S. 897 (1981)). See generally *Bell* v. *Hood*, 327 U.S. 678, 682 (1946).

1920)).[2] Indeed, two cases cited in *Howey* to illustrate the correct Blue Sky law interpretation involved fixed or contractually guaranteed returns. See *People* v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932); *Stevens* v. *Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932).

In arguing to the contrary, respondent misreads those cases. The investment in *White* did not, as respondent asserts, provide "a return in the form of * * * a share in expected capital appreciation" (Resp. Br. 19 & n.12) but instead promised a true fixed return that did not vary with the enterprise's profitability. The investment agreement stated that the investor had given the defendant "$5000 in cash, which is to be used by [the defendant] for investment only until the 30th day of October, A.D. 1930," on which date the defendant "agrees to pay" the investor "the sum of $7,500 * * * as principal and earnings" for the stated period. 12 P.2d at 1079. The agreement did not provide that the $7,500 was due only if the defendant's investments were successful. On the contrary, it specified that payment of a fixed amount was due on a date certain, and the court relied on that fact in holding that the arrangement was an investment contract. *Id.* at 1081 (noting that the contract "plainly provides" that the defendant "agrees to pay a specified sum on a specified date").

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[2] Unable to deny that the terms of the definition of investment contract adopted in *Gopher Tire* and endorsed in *Howey* encompass both fixed- and guaranteed-return investments (see SEC Br. 11-12), respondent seeks (Br. 17-18) to limit the definition's scope to the particular facts of *Gopher Tire*. But the fact that the investment in *Gopher Tire* offered a return that varied in part with the profits of the enterprise (see 177 N.W. at 937-938) does not mean that every "investment contract" must offer such a return, and nothing in *Gopher Tire* or *Howey* supports engrafting that limitation onto the broad language of the "investment contract" definition.

In *Stevens*, one of two contracts held to be securities was an "absentee ownership agreement, called a lease," whereby an investor purchased rabbits for $175 and leased them back to the seller to breed; the seller's literature "guarantee[d]" to pay the purchaser $1 per rabbit for one-half the expected 112 offspring per year and "guarantee[d]" the number of offspring by promising to replace any barren or dead rabbits. 161 A. at 193-194. Noting that the company "guarantee[d]" to pay $1 per rabbit for 56 of the offspring and "guarantee[d]" that the investor's rabbits would produce sufficient offspring by providing replacements as necessary (*ibid.*), the court viewed the contract as "purport[ing] to secure" a fixed return of "$56 a year upon a $175 investment" (*id.* at 195). The promotional materials described the arrangement as offering "32 per cent." "profit" on the $175, and the court characterized that offer as a "guaranty of 32 per cent. income per annum" on the amount invested. *Id.* at 194.

Other state cases cited in *Howey*, 328 U.S. at 298 & n.4, as demonstrating the pre-1933 state-law interpretation of "investment contract" likewise involved schemes promising returns that did *not* vary according to the profitability of the overall enterprise. See *State* v. *Evans*, 191 N.W. 425, 426-427 (Minn. 1922) (installment land sale allowing purchaser to obtain a refund of his payments with a "bonus" of "$70 for each $1,000," or, under certain conditions, to use his total payments plus "interest" for other purposes); *Prohaska* v. *Hemmer-Miller Dev. Co.*, 256 Ill. App. Ct. 331, 338-339 (1930) (land sale in which profits from seller's cultivation of purchaser's individual land, not a share of the profits of any larger operation, were applied to remainder of purchase price). Because those schemes would not qualify as investment contracts under respondent's interpretation, this Court's citation of them as exam-

ples of investment contracts demonstrates the error of respondent's position.[3]

2. Respondent does not dispute the SEC's contention (SEC Br. 20-21, 40-42) that limiting "investment contract" to variable-return investments would create a gap in the coverage of the securities laws. See Resp. Br. 44. Instead, he argues (*id.* at 29-31) that the term "investment contract" is not intended to serve as a "catch-all" to plug gaps in statutory coverage. That argument, however, is belied by this Court's recognition in *Howey*, *Landreth*, and *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), that Congress intended "investment contract" to be a broad, flexible term covering "[n]ovel, uncommon, or irregular devices" (*id.* at 351) that "d[o] not fit squarely within one of the enumerated specific kinds of securities listed" (*Landreth*, 471 U.S. at 690 n.4). Although those cases do not expressly label "investment contract" as a "catch-all," they describe the term as having that function, which is consistent with its broad and general language.

Respondent further errs in his related argument that "investment contract" cannot include fixed-return securities because other terms in the definition of security would then be "redundant." Resp. Br. 30 (quoting *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 574 (1995)). This Court has held that the terms in the definition overlap, and an interest may be an "investment contract" yet

[3] The Blue Sky cases cited by respondent in which the courts declined to find investment contracts also do not support his position. Those cases turned not on the presence of a fixed return but on the fact that the contract holders were not passive investors and instead were required to devote their own efforts to produce the anticipated profits. See *State* v. *Heath*, 153 S.E. 855, 858 (N.C. 1930); *Lewis* v. *Creasey Corp.*, 248 S.W. 1046, 1049 (Ky. 1923). See also *Creasy Corp.* v. *Enz Bros.*, 187 N.W. 666 (Wis. 1922) (contract identical to the one in *Lewis*).

also come within one or more of the other terms. See *Tcherepnin* v. *Knight*, 389 U.S. 332, 339-340 (1967). Respondent also mistakenly suggests (Br. 30) that the term "evidence of indebtedness" is an adequate catch-all for unusual fixed-return securities. That term is not even included in the definition of security in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), and some courts have suggested that the term is limited to written instruments, see *Barack* v. *United States*, 317 F.2d 619, 622 (9th Cir. 1963).[4]

B. Precedent Confirms That Investment Contracts May Have Fixed Or Contractually Guaranteed Returns

1. Respondent's narrow understanding of "investment contract" is also unsupported by precedent. Respondent incorrectly argues (Br. 16-17, 20-21) that the Court's holding in *Howey* depended on a determination that the citrus grove packages offered "a return which would vary based on the success of the business." *Id.* at 21. To the contrary, the returns of the *Howey* investors did not vary with the success of the overall enterprise. Rather, each investor "looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole." *SEC* v. *W.J. Howey Co.*, 151 F.2d 714, 717 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946). A grove might have no "fruitage" for

[4] Respondent is also incorrect in arguing (Br. 1, 32) that coverage of his payphone offerings under the securities laws is not necessary because they may be subject to regulation by the Federal Trade Commission (FTC). FTC regulation would not make the disclosure and antifraud protections of the securities laws unnecessary because FTC disclosure requirements are not aimed at reducing, and do not reduce, the risk that ETS might become insolvent and unable to pay investors their promised returns. Cf. *Marine Bank* v. *Weaver*, 455 U.S. 551, 557-558 (1982); pp. 11-12, *infra*.

several years because only some of the groves were planted with trees that were already "bearing." *SEC* v. *W.J. Howey Co.*, 60 F. Supp. 440, 441 (S.D. Fla.), aff'd, 151 F.2d 714 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946); see also 328 U.S. at 295 (price per acre depended on age of trees). In addition, each investor paid the cost of care for his own grove. "In the care of each grove, as in the yield of the fruit, the costs of the care, and the proceeds of the fruit, * * * [we]re definitely and distinctly accounted for with respect to the specific property owned by the individual." 151 F.2d at 716 n.5; see 60 F. Supp. at 441. Indeed, the absence of a right to a share in the profits of an overall enterprise was among the reasons the *Howey* court of appeals concluded that the interests were *not* investment contracts. 151 F.2d at 717. This Court reversed, necessarily rejecting that reasoning. *Howey* was thus not a case in which each investor received a pro rata share of the profits of the whole orchard based on either the amount of land he owned or the amount of money he invested.[5] Accordingly, *Howey* refutes respondent's contention that an investment contract exists only when each investor's return varies with overall profits.[6]

[5] Respondent relies (Br. 31) on a statement in 2 Louis Loss & Joel Seligman, *Securities Regulation* 951 (3d ed. rev. 1999), that refers to the investment contract test in *Howey* as a test designed to capture "equity" interests, which respondent assumes are equivalent to investments that offer a share of the profits of the overall enterprise. Earlier editions of Professor Loss's treatise, however, specifically recognized that the *Howey* test encompasses other arrangements, and collected cases in which an investment contract was present "without any element of pooling or profit-sharing among different investors." See I Louis Loss, *Securities Regulation* 489 & n.86 (2d ed. 1961); Louis Loss, *Securities Regulation* 318-319 & n.39 (1st ed. 1951) (same).

[6] Although the issue is not before the Court, *Howey* also refutes respondent's contention (Br. 34 n.18) that an investment contract must demonstrate "horizontal commonality"—a correlation among the profits of individual investors. Because the profits of each *Howey* investor depended on the yield and costs of the investor's own plot, investors' returns were independent of one another. Even if "horizontal commonality" is required, however, it is present here. Each payphone investor expected to receive his contractually specified return not from the earnings of his individual phone, but from the earnings of the overall venture. An investor's funds were not segregated and used to maintain only his particular phone, but were pooled to operate the overall payphone enterprise. Moreover, ETS's ability to meet its obligations to existing investors was dependent on its ability to bring in new investors. Thus, investors were dependent on one another for their returns.

Howey also cited several federal court decisions as correctly applying the broad interpretation of "investment contract" that this Court was adopting. 328 U.S. at 299 n.5. As noted in the SEC's opening brief (at 24, 31), one of those cases—*SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940)—involved a scheme offering a fixed return. Contrary to respondent's contention (Br. 42, 47), the return in *Universal* was *not* contingent on the promoters' profits. Upon payment of "$1.00 per month for five years" ($60), each investor was promised title to a farm "worth $150" or that amount in cash, which represented a return of "30% per annum profit." 106 F.2d at 234. The investor's contribution was used in the promoters' agricultural enterprises, but the 30% return was not dependent on earnings from those enterprises, and nothing prevented the promoters from using other sources to pay the promised return.[7]

[7] It would thus make no difference if, as respondent suggests (Br. 5), he did not represent that the "lease" payments would come specifically from ETS's payphone operations. It is, however, clear that investors were led to believe that their returns would come from that source. As discussed at pp. 14-15, *infra*, the promotional

Indeed, the court of appeals emphasized that the scheme offered "*assured* profit of 30% per annum with *no chance of risk or loss to the contributor.*" *Universal*, 106 F.2d at 234 (emphasis added). Moreover, that guaranteed return was represented to investors as a percentage of the amount they paid in, not a percentage of the earnings of the enterprise. See *ibid.* *Howey*'s endorsement of *Universal* thus confirms that an investment contract may have a fixed, contractually guaranteed return that is not linked to the profits of the overall enterprise.

Three other cases cited with approval in *Howey* also involved arrangements that would be excluded from the "investment contract" category under respondent's interpretation because the investors' returns did not vary with the profits of the overall enterprise. For example, in *SEC* v. *Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940), each investor in the fox-breeding scheme received the profits from the sale of his own specifically identified foxes. *Id.* at 875. Contrary to respondent's assertion that there was a "pro-rata sharing in the profits" (Br. 37 n.21), the court expressly noted that the scheme had been modified to "eliminate[] * * * the pooling of foxes * * * and * * * the pro rata distribution" of the overall proceeds. 35 F. Supp. at 875. The court nonetheless held the scheme to be an investment contract. *Id.* at 877-878. Likewise, in *SEC* v. *Bourbon*

materials, including ETS's website, touted ETS's profitable operation of payphones and made no mention of any other businesses operated by the company. Further, respondent admits (Br. 7 n.6) that he wrote a letter on July 1, 2000 (J.A. 229-230), in which he responded to "questions from our Lessors" about the profitability of ETS's payphone operations. "Lessors" would likely have been concerned about the profitability of those operations because they expected ETS's payphone earnings to fund their monthly "lease" payments, as the promotional materials suggested.

Sales Corp., 47 F. Supp. 70, 71 (W.D. Ky. 1942), and *SEC* v. *Bailey*, 41 F. Supp. 647, 649 (S.D. Fla. 1941), each investor appears to have received profits from only his own specific property.[8]

2. This Court's post-*Howey* decisions also do not support respondent's contention that investment contracts must offer returns that vary with the profits of the overall enterprise. In *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), the Court held the pre-maturity portion of a deferred annuity plan to be an investment contract, even though that portion of the plan offered, as one of two alternative returns, a "guarantee of cash value based on net premiums." *Id.* at 211. See SEC Br. 26-27. Respondent thus misreads *United Benefit* in contending (Br. 21-22) that the portion of the annuity held to be an investment contract offered only a variable return. The guarantee included in that portion of the annuity set a floor below which the investor's return did *not* vary with the profits of the enterprise. *United Benefit* thus confirms that "investment contract" is not limited in the way respondent claims.

[8] Respondent disputes (Br. 37-41) the SEC's reliance (Br. 27-29) on two court of appeals decisions holding that investment contracts may promise fixed returns: *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), and *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978). He concedes that the cases so held but claims that the holdings have no bearing here because "both courts were addressing the 'common enterprise' element of *Howey* and not the 'profits from the efforts of others' element." Resp. Br. 38. It does not matter, however, what aspect of the *Howey* description of "investment contract" those courts were addressing. Pet. Reply 7-8. Both held, contrary to the court of appeals here, that a fixed return does not exclude an investment from the statutory term.

Respondent's reliance on other decisions of this Court is likewise misplaced. Several involved insurance or bank products, which are subject to other regulatory regimes aimed at ensuring the solvency of the entity issuing the product. See *Marine Bank*, 455 U.S. at 557; *Tcherepnin*, 389 U.S. at 337; cf. *SEC* v. *Variable Annuity Life Ins. Co.* (*VALIC*), 359 U.S. 65, 69-70 (1959). If the return offered by such products is fixed, and purchasers thus are dependent only on the issuer's solvency, the protections of the securities laws may be unnecessary because the separate regulatory scheme directly protects against the risk of insolvency. See Br. for the U.S. as Amicus Curiae at 10-15, *Marine Bank*, *supra* (No. 80-1562); *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring). In *Tcherepnin*, however, where investors were dependent on factors other than the bank's solvency, the interests were held to be securities. In none of those cases did the Court suggest that a fixed return might preclude an arrangement from being an investment contract even where, as here, no separate regulatory regime protects investors against the risk of the issuer's insolvency.[9]

Nor, contrary to respondent's claims (Br. 23, 26-27), do this Court's decisions in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), and *Reves* v. *Ernst & Young*, 494 U.S. 56 (1990), restrict the meaning

[9] Decisions of four courts of appeals involving commercial bank "loan participations," relied on by respondent (Br. 36), mention a fixed return as a factor in the determination that the products sold were not investment contracts. As discussed in the SEC's opening brief (at 30 n.11), however, those products were not investment contracts because of their commercial, rather than investment, nature. Contrary to respondent's contention, the context in which the products were sold (*e.g.*, to whom and for what purpose) is clearly relevant to whether they were investment contracts. See *Marine Bank*, 455 U.S. at 560 n.11.

of "profits" under *Howey*'s definition of "investment contract" to variable returns. *Reves*, as respondent acknowledges, "did not purport to alter the meaning of 'profits' from its use in *Howey*" (Resp. Br. 27) but only to mention in passing how the Court had previously construed "profits" in *Forman*. See SEC Br. 36-37. That passing reference in a footnote, which was "irrelevant" to the Court's holding in *Reves* (494 U.S. at 68 n.4), was simply not (and was plainly not intended to be) a precise or comprehensive definition of "profits" for purposes of the *Howey* test. Nor did *Forman* itself limit the meaning of "profits" to variable returns. Indeed, the SEC's opening brief (at 35-36) identifies several statements in *Forman* that indicate that the Court understood "profits" to have its ordinary broad meaning, which encompasses fixed returns. For example, the Court equated "profits" with "financial returns" and with "income or profits," 421 U.S. at 853, 855, terms that plainly include fixed returns such as interest or rent (see SEC Br. 35-36). Respondent ignores those statements in *Forman* and merely quotes other snippets that might—read out of context—support a limitation to variable returns, but that in context do not, as the SEC's opening brief (at 34-35) demonstrates. The correct test, the Court summarized in *Forman*, is whether "the investor is 'attracted solely by the prospects of a return' on his investment" (421 U.S. at 852 (citing *Howey*, 328 U.S. at 300)), rather than a desire to use or consume a purchased item (*id.* at 853). That test is clearly satisfied here.[10]

[10] *Teamsters* v. *Daniel*, 439 U.S. 551 (1979) (cited at Resp. Br. 24) also provides respondent no support. The Court held that there was no investment contract in *Daniel* because the pension benefits depended primarily on the employee's efforts to meet the vesting requirements, not on the investment success of the retire-

3. Respondent also argues (Br. 3, 32-33) that the payphone investment packages are not investment contracts under the principle (reflected in *Joiner* and *United Benefit*) that promoters are held to the representations that they make to prospective purchasers. See SEC Br. 25-26. Respondent claims that he did not represent that prospective investors would receive "profits" from their payphone packages. But the SEC's complaint alleged that the promotional materials made such representations (J.A. 13), and that is sufficient to preclude dismissal. In any event, the evidence presented at the preliminary injunction hearing fully supports the complaint's allegations. The promotional materials, including ETS's brochure describing the lease program, referred to "profits" for "owners" of payphones. See SEC Br. 4; Pet. Reply 5 n.3; J.A. 100-102, 114-115, 117-120, 124. And ETS's publicly available website represented that "profitable opportunities" were available in the payphone industry and "pay phone owners" could expect to receive "profits" through ETS. See J.A. 223 ("pay phone owner" could "maximize[]" "profits" through "management expertise provided by ETS Payphones"); J.A. 227 ("profits for individual pay phone owners"; "pay phone industry has grown into a highly profitable venture"; "pay phone ownership offers a unique business environment"); J.A. 228 ("millions to be made from owning pay phones").

Respondent attempts (Br. 3, 32-33) to distance himself from the representations about "profits" contained in brochures and websites of the "distributors." But respondent admitted that he saw the brochures used by the distributors and knew that they marketed the

ment fund. 439 U.S. at 561. The linchpin of the Court's analysis was that the employee's return depended on his *own* efforts rather than the "efforts of others" as in *Howey*.

phone packages with a document "similar" to a brochure used by ETS, which he himself had designed. J.A. 48-49. Although respondent contends (Br. 33) that the ETS brochure was not "directed" to payphone owners, the brochure repeatedly refers to "profits" for payphone "owners" to be derived from ETS's management of the phones. J.A. 114-120. Further, respondent has never disputed that he recorded payphone sales revenues as income to ETS (see J.A. 45) and that, under the leases, ETS contracted to refund to each investor, upon request, the full purchase price the investor had paid to the distributor for the "payphone equipment and location" (J.A. 129). Respondent cannot seriously dispute that he is responsible for the representations made in the marketing materials.

C. The SEC Has Consistently Interpreted "Investment Contract" To Include Fixed- And Guaranteed-Return Investments

Respondent is also wide of the mark in arguing (Br. 44-49) that the SEC has not been consistent in its position that investment contracts may have fixed or guaranteed returns and that the SEC's interpretation is not entitled to deference. As early as 1936, the SEC took the position in an enforcement action that a fixed-return investment was an "investment contract," see p. 9, *supra* (discussing *SEC* v. *Universal Serv. Ass'n)*, and it has not wavered in that view. Its longstanding position, embodied in a variety of forms, including formal adjudications, is entitled to deference. SEC Br. 31-33.[11]

[11] Respondent errs in arguing (Br. 44-45) that deference under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), is barred by stare decisis because this Court's decisions in *Forman* and *Reves* removed any ambiguity about whether the term "investment contract" includes fixed-return investments. As explained at pp. 12-13, *supra*, *Forman* and *Reves* did not involve or purport to resolve the question whether a fixed-

For example, *Los Angeles Trust Deed & Mortgage Exchange* v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961), *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), and *In re Union Home Loans*, 26 SEC Dkt. 1346 (Dec. 16, 1982), involved investment contracts comprised of mortgage notes coupled with services performed by the promoters. In all those cases, the investors' returns were fixed amounts—interest on the notes that were part of the packages. Respondent's contention that *Abbett* did not involve a fixed return because the *services* the promoter performed "were directed essentially toward minimizing the risk involved in the investment" (Br. 48 (quoting *Abbett*)) makes no sense. The investors' returns were the fixed interest amounts they expected to receive on the mortgage notes. Although the notes might not have been investment contracts if they had not been packaged with the services, the services (whatever their nature) did not transform the investors' expected returns into variable amounts. Both *Abbett* and *Union Home Loans* were formal adjudications, and the long-standing interpretation of "investment contract" reflected therein is therefore entitled to *Chevron* deference. See *SEC* v. *Zandford*, 535 U.S. 813, 819-820 (2002) (citing *United States* v. *Mead Corp.*, 533 U.S. 218, 229-231 (2001)).[12]

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return investment may be an "investment contract," and the SEC's interpretation that it may, which dates from at least 1936 and is embodied in a 1969 adjudication, predates both *Forman* and *Reves*.

[12] As noted in the petition reply (at 9), the fact that the subject of the SEC's order in *Union Home Loans* did not contest the charges did not render the proceeding something other than an adjudication entitled to *Chevron* deference. In any event, *Union Home Loans* did not announce a new position, but reiterated the SEC's interpretation in *Abbett*, a contested case.

Respondent also errs in asserting (Br. 47-48) that the SEC release, *Applicability of the Securities Laws to Multi-Level Distributorships and Pyramid Sales Plans*, SEC Release Nos. 33-5211 & 34-9387 (Nov. 30, 1971), is inconsistent with the SEC's argument here and suggests that an "investment contract" must be an equity interest. Although the release assumed that *Howey* itself "described an investment contract providing the investor with an equity interest" (*id.* at 3), nothing in the release's *Howey* discussion suggests that investment contracts are *limited* to equity interests or that they exclude fixed-return investments. In fact, the release made the opposite point, stating that it is not "significant that the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise," and that, "where the interest offered is of a different nature" than in *Howey*, *i.e.*, *not* an equity interest, "the promised return will necessarily vary," *i.e.*, "may be something other than a share of the profits of the enterprise." *Ibid.*

The release specifically identified "cash fees" for "the recruitment of additional participants" as one form of return offered in the pyramid sales schemes that the SEC considered to be investment contracts. SEC Release Nos. 33-5211 & 34-9387, at 4. Although the return in such schemes is not a fixed sum, because the total amount varies with the number of new victims each investor finds, the investor's return does *not* vary with the overall earnings of the enterprise, as respondent insists is required for an investment contract to exist. Thus, the release is consistent with the SEC's argument here, and with its interpretation in the adjudications and enforcement actions that have deemed "investment contract" to include fixed-return schemes.

D. Respondent's Other Arguments Also Lack Merit

Respondent also proffers various other objections to classifying the payphone arrangements as investment contracts. None is persuasive. Respondent contends (Br. 2, 49) that two separate companies, both wholly owned by him, carried out different parts of the payphone business. But *Howey* likewise involved two separate companies and two separate contracts. 328 U.S. at 294-295. The division of tasks did not remove the interests in *Howey* from the scope of investment contract, and it does not do so here. Respondent also contends (Br. 5-6) that the investors' payphones had intrinsic value and investors could take possession of them if ETS failed to make the lease payments. But that fact, if true, is also irrelevant. In *Howey*, the promoters sold fee simple interests in specific strips of land along with the service contracts (328 U.S. at 293, 299), but that did not preclude the existence of an investment contract. See *id.* at 301 ("it is immaterial * * * whether there is a sale of property with or without intrinsic value"). Respondent also notes (Br. 4, 6) that investors were not required to use ETS to manage their phones. In *Howey*, however, investors likewise were not required to use the promoters' service company, and 15% of them did not do so. 328 U.S. at 295. "[A]t least seven" other companies were available to perform similar services. 151 F.2d at 716 n.5.[13]

[13] Contrary to respondent's suggestion (Br. 4), at least one of the payphone packages that he offered in addition to the lease program was almost certainly also an investment contract. "Option II," under which a phone purchaser paid ETS fees to perform all phone management functions and received the net profits from his phone (J.A. 127-128), is analogous to the investment contracts in *Howey* (see 328 U.S. at 296; 151 F.2d at 716 n.5, 717). The SEC did not include Option II in its complaint because 99% of phone purchasers chose Option III, the lease program. See J.A. 164.

Finally, respondent incorrectly implies (Br. 2, 49) that the payphone interests should not be held to be securities because he purportedly structured the business in accordance with advice that an SEC attorney gave him in 1995. The record refutes respondent's claim of reliance (J.A. 61-64, 160), and, in any event, a government attorney's alleged promise not to take enforcement action would not bind the SEC in its interpretation of the securities laws. See *Utah Power & Light Co.* v. *United States*, 243 U.S. 389, 408-409 (1917) (cited with approval in *Office of Personnel Management* v. *Richmond*, 496 U.S. 414, 420 (1990)); *SEC* v. *Culpepper*, 270 F.2d 241, 248 (2d Cir. 1959).[14]

* * * * *

Respondent sold the payphone packages to raise capital to operate his business. See SEC Br. 3, 13; J.A. 158. He promoted them as passive investments through which investors could obtain "profits," and investors entrusted their money to him for that purpose. See SEC Br. 3-4; pp. 14-15, *supra*. Those investment agreements are precisely the kind of arrangements that Congress sought to regulate as securities under the federal securities laws. They fall squarely within the term "investment contract," the broad and general language of which is designed to cover unusual arrangements that do not fit comfortably within one of the enumerated specific kinds of securities. They fall squarely within the meaning the term "investment contract" had

[14] Respondent also relies (Br. 49) on the SEC attorney's purported advice to bolster his claim (see pp. 15-17, *supra*) that the SEC has been inconsistent in its position that an investment contract may have a fixed return. But the advice he claims the attorney gave him—to separate the operation into two companies—has nothing to do with the fixed nature of the return and is not inconsistent with any SEC interpretation on that issue.

acquired under the Blue Sky laws that served as the model for the federal securities laws. And they fall squarely within the meaning that term has been given by the SEC and the courts in the 70 years since those laws were enacted.

Respondent's proposal to limit the scope of "investment contract" to investments offering a return that varies with the profits of the overall enterprise is a radical departure from the enforcement history of the securities laws. The limitation that he proposes would deny "the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that" fall outside the rigid per se rule he proposes. *Reves*, 494 U.S. 56, 63 n.2. Indeed, respondent's proposed rule, like the court of appeals' decision, provides a blueprint for unscrupulous promoters to circumvent the securities laws simply by structuring the returns offered by their investment schemes as fixed or guaranteed amounts. That result would frustrate Congress's intent "to regulate *investments*, in whatever form they are made and by whatever name they are called," *id.* at 61, and it should not be sanctioned by this Court.

For the reasons stated above and in the SEC's opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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In The

Supreme Court of the United States

THE SECURITIES AND EXCHANGE COMMISSION, PETITIONER,

v.

CHARLES E. EDWARDS, RESPONDENT.

ON A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF OF THE SECURITIES REGULATORS FOR THE STATES OF FLORIDA AND COLORADO AS *AMICI CURIAE* IN SUPPORT OF THE SECURITIES AND EXCHANGE COMMISSION

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QUESTIONS PRESENTED

1. Whether a return on an investment should be excluded from the meaning of "profits" under the *Howey* test for investment contracts merely because the promoter of the investment offers a fixed rate of return.

2. Whether a return on an investment, which is in fact wholly dependent upon the effort of others, should nevertheless be viewed as not "derived from the efforts of others" under *Howey* merely because the promoter contractually promises or guarantees the return.

INTERESTS OF THE AMICI CURIAE

The *Amici Curiae*, the State of Florida Department of Financial Services, Office of Financial Institutions and Securities Regulation and the State of Colorado Department of Regulatory Agencies Division of Securities ("*Amici Curiae*"), through undersigned counsel, are responsible for regulating the securities industry within their respective states.[1] As regulatory agencies overseeing the securities industry, the *Amici Curiae* are extremely concerned with the potentially devastating effect the Eleventh Circuit's decision in this case, i.e., holding that investments in ETS Payphones, Inc., do not qualify as securities, may have on the efforts of the various state securities regulators to protect the investing public.

STATEMENT

The *Amici Curiae* recognize the significant demands placed on this Court's time and resources and, out of respect for such, have opted to forego the filing of a lengthy detailed brief. Instead, the *Amici Curiae* wish to simply state that the level of their concern over the Eleventh Circuit's ruling has not diminished since the filing of their *Amici Curiae* brief in support of the Securities and Exchange Commission's Petition for

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[1]Pursuant to Sup. Ct. R. 37.6, the Amici Curiae represent that no counsel for any party authored this brief in whole or in part, and no person or entity, other than the Amici Curiae, made any monetary contribution to the preparation or submission of the brief. Pursuant to Sup. Ct. R. 37.3, the Amici Curiae represent that both parties to this appeal consented to the filing of this amicus brief. Copies of their written consents are being filed with this brief.

Certiorari. Indeed, if anything, their concern has been heightened by the number of requests received from previously disciplined entities and individuals requesting that the disciplinary decisions be reversed based on the Eleventh Circuit's ruling. Those requests, coupled with a number of cases in which the Eleventh Circuit's decision has been cited as a basis for not taking regulatory action at all, have given rise to concern over the *Amici Curiae*'s abilities to continue to effectively protect the investing public from fraudulent or questionable investment schemes.

The *Amici Curiae* hereby incorporate the arguments set forth in their *Amici Curiae* brief in support of the Securities and Exchange Commission's Petition for Certiorari as though said arguments were set forth in full herein. Additionally, the *Amici Curiae* support and adopt the arguments set forth in the North American Securities Administrators Association, Inc.'s ("NASAA") *amicus curiae* brief on the merits in this case.

CONCLUSION

For the reasons set forth above and discussed in depth in the briefs identified above, the *Amici Curiae* respectfully request that the Eleventh Circuit's decision be reversed.

Respectfully submitted.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 2002

THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Appellant,

AGAINST

ETS PAYPHONES, INC.
AND
CHARLES E. EDWARDS,

Appellees.

On Appeal From the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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June 26, 2003

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MOTION FOR LEAVE TO FILE BRIEF FOR PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

The Public Investors Arbitration Bar Association, Inc. ("PIABA") is a national non-profit voluntary public bar association with a membership of some 550 attorneys. In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters. PIABA hereby respectfully moves for leave to file the attached brief, as **Amicus Curiae**, in the present case. Permission of the appellant, the United States Solicitor General, has been obtained. Permission of Charles E. Edwards, appellee, was sought and denied.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar interests in payphones offered by other companies. The decision of this Court could strongly influence the outcome of these future arbitrations.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. These investments include automated teller machines, credit card processing units, and Internet access terminals, among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied the information and protection which the state and federal securities acts were designed to provide.

The focus of the brief of the Solicitor General on behalf of the Securities and Exchange Commission is limited to the Eleventh Circuit's analysis of the ETS payphone operation and its implications decision on the federal securities acts. The brief, which PIABA as **Amicus Curiae** seeks permission to file, will, however, have a wider focus. It will address the impact of this Court's decision on arbitration, state securities laws, and other types of similar schemes. It will provide the Court with an understanding of the potential impact that the Court's decision will have in these broader areas.

Respectfully submitted,

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In the
Supreme Court of the United States
October Term, 2002

The United States Securities and Exchange Commission,

Appellant,

against

ETS Payphones, Inc.
and
Charles E. Edwards,

Appellees,

On Appeal From the United States Court
of Appeals for the Eleventh Circuit
Brief for the Public Investor's Arbitration
Association, Inc., as Amicus Curiae

STATEMENT OF INTEREST OF THE PUBLIC INVESTOR'S ARBITRATION BAR ASSOCIATION, INC.

The Public Investors Arbitration Bar Association, Inc.("PIABA"), is a national non-profit voluntary public bar association with a membership of some 550 attorneys. In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar

interests in payphones offered by other companies. The decision of this Court will strongly influence the outcome of these actions.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. There are similar investment plans presently being offered to the general public involving automated teller machines, credit card processing units, and Internet access terminals among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied the information and protection which the state and federal securities acts were designed to provide.

SUMMARY OF ARGUMENT

PIABA believes the SEC has greatly understated the true issue in the present case. The real issue is whether any debt security or contract requiring the payment of a fixed return can be an investment contract. The Eleventh Circuit interpreted this Court's decision in **United Housing Foundation v. Forman**, 421 U.S. 837 (1975), defining the "profit" element of **Howey**[1] test for investment contracts, to exclude either the payment of interest or a contract fixed-return obligation. It reached this conclusion based upon its reading of **United Housing** requiring that the investor's profit must come from the earnings of the company. Interest or fixed return contract obligations may or may not come from the earnings of the enterprise because these obligations must be paid without regard to whether the enterprise earns a profit.

The correctness of this interpretation is a matter of national public interest. Both the SEC and the state securities

[1]SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

agencies spend a great deal of their enforcement resources dealing with novel or unusual securities. By far the most used portion of the statutory definition of a security in these cases is that of "investment contracts." Virtually all these novel securities cases also involve either Ponzie schemes or fraudulent conduct, often aimed at the unsophisticated and the elderly. The losses to the general public are enormous.

To understand the size of the problem, it should be noted that in addition to the SEC, at least 18 state securities agencies have taken action against ETS.[2] When enforcement activities against other payphone operations are included, the number of state enforcement actions soars to over 200.[3] The State of California alone has issued 143 Desist and Refrain Orders against 54 such entitles.[4]

This is, however, merely the tip of the iceberg. In the past, the agencies have had to deal with similar schemes involving automatic teller machines and other sale and lease-back promotions ranging from railroad cars to trailer trucks. *See e.g.*, **United States v. Jones**, 712 F.2d 1316 (9th Cir.), *cert. denied*, 464 U.S. 986 (1983)(trailer trucks).

These problems will also continue into the future. Ads are presently running on national television offering similar contracts on both Internet site locations and credit card confirmation

[2]See e.g., In re ETS Payphones, Inc., 2002 WL 1586379 (Ind. Div. Sec. June 7, 2002); In re ETS Payphones, Inc., 2001 WL 422179 (Ala. Sec. Com. Feb. 6, 2001); and In re National Communications Marketing, Inc., 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001).

[3]Westlaw search, MSEC-CS, payphones /s securities. The search was done on March 11, 2003.

[4]Cal. Corp. Comm'n, Press Release 00-16 (2000), available at www.corp.ca.gov.

machines. Many are advertising that they are the successor to the payphone opportunities!

Beyond the sale and lease-back cases, the SEC and state agencies have had to deal with wide-spread Ponzi schemes involving promissory notes and international banking transaction frauds. *See e.g.*, **State v. Gerisch**, 49 P.3d 392 (Idaho 2002); **Mosley v. State**, 253 Ga. App. 710, 560 S.E.2d 305 (2002) The states have also been faced with the fraudulent sale of viatical settlement contracts.

If the Eleventh Circuit decision is upheld, the SEC will lose its most effective weapon to control and combat these schemes. Further, while the state courts are not obligated to follow federal decisions, they often do. Thus, a huge gap in both the federal and state agency enforcement programs will result. The white collar criminals will have carte blanche to conduct these various schemes with impunity.

The problem will also hamper criminal prosecutions and civil recovery. If the interests are not investment contracts or securities, criminal enforcement actions, such as **Szpunar v. State,** 783 N.E.2d 1213 (Ind. App. 2003), could not be brought. Nor would the state agencies be able to bring administrative actions and civil injunctive proceedings, such as **King v. Pope**, 91 S.W.3d 314 (Tenn. 2002).

This brief will attempt to accomplish two things. First, it will address why the Eleventh Circuit's position in the present case is wrong and should be overruled. Then, it will outline the two approaches the Court can take in overruling the Eleventh Circuit and establishing a meaningful and consistent public policy in this area.

There are numerous reasons why this Court should reverse the decision of the Eleventh Circuit. PIABA will demonstrate that the Eleventh Circuit's reading of **United Housing** was mechanical and unwarranted. It will also show that the **United**

Housing restrictions on "profits" are not supported by this Court's prior cases and the origins of the "investment contract" concept. Finally, PIABA will show that the **United Housing** restriction, as interpreted by the Eleventh Circuit, is inconsistent with the decisions of the other federal courts, the SEC, the state courts, and the state securities agencies.

Assuming that the Court is willing to overturn the Eleventh Circuit's decision, PIABA will then outline how the Court can accomplish this result. PIABA believes that the Court can accomplish this task in either of two ways.

The easiest and simplest approach would be to rule that interest or any fixed income can be considered a "profit" under the third element of the **Howey** test. While this approach will accomplish the appropriate result and is attractive because of its simplicity, PIABA would urge the Court to follow the second approach.

The Court should use this case as a vehicle for a broad rethinking of the elements of an investment contract and of a security in general. During the last fifty years, since the decision in **SEC v. W.J. Howey Co.**, the Court has dealt with the definition of an investment contract and that of a security in general on a piece-meal basis. Time is overdue for the Court to take the time to harmonize its various pronouncements as to what is a security and develop a single logical approach to this issue which is consistent with the intent of Congress in passing the Securities Act of 1933. In other words, in a logical and consistent manner, the Court needs to identify the elements of "securitiness" as well as of investment contracts.

In performing this task, the Court should determine the true nature of "securitiness" and a number of artificial tests which have grown up in the lower federal courts. The cases are largely the result of the Court's imprecision in its past pronouncement on the subject. The test should not be burdened with restrictions or

limitations which have no relevance to defining that which Congress sought to regulate in passing the Securities Act of 1933.

This Court, in many other areas, has sought to return to the original intent of Congress as determined by the language of the statute itself, its legislative history, and historical development as gleaned from similar statutes which Congress sought to use as a drafting model. The need is for a test to identify in a consistent and rational way, what are the elements of "securitiness."

In summary, PIABA urges the Court to reverse the decision in the present case and undertake the task of identifying the appropriate elements of "securitiness".

ARGUMENT

Technically, there is only one issue before the Court. This question is whether the Eleventh Circuit was correct in holding that an obligation to pay a fixed monthly amount for the use of payphones under a purchase and service contract prevents that agreement from being an investment contract. The Eleventh Circuit concluded that "the expectation of profits" element of the **Howey** test is not met by any interest-bearing agreement or contract requiring the payment of a fixed return. In doing so, the Eleventh Circuit interpreted **United Housing Foundation v. Forman**, 421 U.S. 837 (1975), which defined the "profit" element of **Howey** test to exclude either the payment of interest or a fixed-return. This conclusion was based upon its reading of **United Housing** to require that the investor's profit must come from the earnings of the company or enterprise. Interest bearing or fixed-return obligations may or may not come from such earnings because these debts must be paid without regard to the enterprise's profit.

POINT I

UNITED HOUSING DOES NOT JUSTIFY THE EXCLUSION OF PAYMENT OF INTEREST AND OTHER FIXED AMOUNTS FROM THE "PROFITS" ELEMENT OF THE HOWEY TEST

The language of **United Housing** does not require the exclusion of fixed-return or interest-bearing instruments from being investment contracts. Nor do the prior decisions of this Court. Further, such exclusion finds no support in either the policy behind the Securities Act of 1933 or the state law origins of the "investment contracts" concept.

A. THE LANGUAGE OF UNITED HOUSING DOES NOT DEMAND SUCH RESULT

The language of **United Housing Foundation, Inc. v. Forman**, 421 U.S. 837 (1975), does not require the interpretation given to it by the Eleventh Circuit. The thrust of **United Housing** was to distinguish those cases where the receiving of a true "profit" was the motivating force behind the investor's investment from those cases where the purchaser of the property was motivated by "the desire to use or consume the item purchased...." 423 U.S. at 852. In attempting to make this distinction, the Court made the following statement about the "profits" element of the **Howey** test, which the Eleventh Circuit relied to exclude interest-bearing and fixed-return contracts from coverage as investment contracts.

> **[The Howey] test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of**

> **others.** By profits, the Court has meant either capital appreciation resulting from the development of the initial investment as in **Joiner, supra**, ... or a **participation in the earnings resulting from the use of investor's funds**, as in **Tcherepnin v. Knight**.... **In such cases the investor is 'attracted solely by the prospect of a return' on his investment.** Id. [Emphasis added.]

The first example of "profits," capital appreciation, does not cause any problem. It is the second clause "a participation in the earnings resulting from the use of the investor's funds" which causes the problem. Read out of context, the phrase "earnings resulting from the use of investor's funds" could lend support to the Eleventh Circuit exclusion of debt and fixed payment instruments, if earnings are defined as gross or net profits of the enterprise. These obligations as debts must be paid regardless of profits or earnings. However, the Eleventh Circuit's interpretation is not the only possible interpretation. PIABA suggests that it is not the best interpretation for two reasons.[5]

First, the language must be put in context. When this is done, several things are clear. It is evident that the Court believes the **Howey** test, including its profits element, to be the litmus test for securities in general. If this is true, debt instruments can not be excluded because notes, bonds, debentures, and evidences of indebtedness are specifically included within the statutory definition. Thus, there would seem to be no intent to exclude interest or other fixed-payment instruments. Also, the questionable language is followed by the last sentence which reads: **"In such cases the investor is 'attracted solely by the prospect of a return' on his investment."** The emphasis here

[5]See a more detailed discussion of these reasons, in the Author's treatise, Blue Sky Law §2:58 (2002).

is on the expectation of a **return** to the investor. "Return" includes interest, dividends, and fixed-return payments.

Finally, it is clear that the language used was an example based upon the **prior** cases of the Court. As it happens, the Court, at that time, had never considered an investment contract case involving either a fixed return or a debt security.[6] Recognizing this fact, the Fifth Circuit in **Meason v. Bank of Miami**, 652 F.2d 542, 550, N.17 (5th Cir. 1981), commented that the quoted language "seems to us to be dubious value in [the note] context."

These three factors, taken together, mitigate against an intent to exclude some types of returns such as interest or fixed payments.

Second, if read the way the Eleventh Circuit did, the focus of the "profits" element would be reversed. The **Howey** test focuses on the **expectation** of a profit **to the investor**. **It does not focus on the enterprise in which the investment is made making a profit.** The investor doesn't care whether the enterprise makes a profit so long as his expectation of a return is fulfilled.

For example, in **Bell v. Health-Mor, Inc.**, 549 F.2d 342 (5th Cir. 1977), the investor was to receive ten dollars off the cost of his vacuum for every referral made. **The ten dollars was paid whether the referral bought a vacuum or not.** All that was required to receive the ten dollars was for the referral to allow a demonstration of the vacuum. The Fifth Circuit held the agreement to be an investment contract, despite the fact that the vacuum cleaner company might not make a profit because no sale is made.

[6]The Court has considered variable annuity contracts in SEC v. United Benefit Ins. Co., 387 U.S. 202 (1967) which have a fixed-return floor on the investment. The focus of the case, however, for investment contract purposes, was on the variable annuity feature.

The basis for the Eleventh Circuit's exclusion of fixed-return or interest-bearing debt securities on the other hand is that the enterprise must pay these obligations, so long as it is solvent, **without regard to whether it makes a profit**.

B. EARLIER SUPREME COURT CASES DO NOT SUPPORT THE EXCLUSION OF FIXED-RETURN OR INTEREST BEARING INSTRUMENTS FROM COVERAGE UNDER THE INVESTMENT CONTRACT ANALYSIS

This Court's first decision to deal with the concept of an investment contract was **SEC v. C.M. Joiner**, 320 U.S. 344 (1943). The Court in **Joiner** recognized that the definitions of a security found in both the Securities Act of 1933 and the Exchange Act of 1934 are not true definitions. Instead, they were definitions by enumeration. Some of the instruments named in the definition were "pretty much standardized and the meaning alone carries well settled meaning." 320 U.S. at 351. "Others are of a more variable character and were necessarily designated by more descriptive terms, such as ... 'investment contract'...." *Id.*

It also recognized that:

> [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing [that] established [them] as 'investment contracts.' Id.

Finally, the Court concluded:

> The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic

> inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offering be judged as being what they were represented to be.[7]

Id. at 352-353.

The Court found the oil and gas interests offered by Joiner were investment contracts. In doing so, it refrained from providing a test to identify "investment contracts." Nothing, however, in the Court's decision hints that fixed-return or debt securities should be excluded from classification as "investment contracts."

Three years later, in **SEC v. W.J. Howey Co.**, 328 U.S. 293 (1946), again considered what constituted an investment contract. The Court made two important observations in **Howey.**

First, it noted that the term "investment contracts" was not a defined term either in the statute itself or the legislative history. However, the term had been in use under the state securities or Blue Sky laws where "it had been broadly construed by state courts so as to afford the investing public, a full measure of protection."

Then, the Court went on to note that "investment contracts":

> [E]mbodies a flexible rather than static principle, one that is capable of adaptation to meet the

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[7]This statement is particularly important in the present case because it emphasizes what the investors thought they were getting. In this case, the contracts were technically cast in the form of fixed payments for rent of the phone. From the perspective of many investors, they were making an investment which would receive a return on that investment, and would not participate in the management of the investment. They were buying an investment contract, not a contract for the payment of rent on a payphone.

> countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. *Id.* at 299.

Finally, the Court announced the now famous test for an investment contract:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. *Id.* at 298-299.

Based on this discussion, the Court concluded the scheme in **Howey** was an investment contract. Again, there is nothing in the language used or the Court's discussion which suggests that the profit can not be in the form of fixed payments or interest on debt securities. In fact, the SEC notes that two of the state cases relied upon by the Court in **Howey** involved fixed income or "guaranteed" returns. *See* **People v. White**, 12 P.2d 1078 (Cal. App. 1932) and **Stevens v. Liberty Packing Corp.**, 161 A. 193, 195 (N.J. Ch. 1932).[8]

The only support for the Eleventh Circuit's position is the *dicta* in **Reves v. Ernst & Young**, 494 U.S. 56 (1990). In **Reves**, the Court established when promissory notes would be securities. In footnote 4, the Court discussed the concept of "profits." It first said: "We emphasize that by 'profits' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest."

Then it added the following *dicta*:

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[8]For a detailed discussion of these cases and the other state and lower federal court cases cited in **Howey**, see the Author's treatise, Joseph C. Long, Blue Sky Law §§1:17-1:18 (2002).

> We have, of course defined "profit" more restrictively in applying the **Howey** test to what are claimed to be investment contracts. [Citing **Forman**] To apply this restrictive definition to the determination whether an instrument is a "note" would be to suggest that notes paying a rate of interest not keyed to the earnings of the enterprise are not "notes" within the meaning of the Securities Acts. Because the **Howey** test is irrelevant to the issue before us..., we decline to extend its definition of "profits" beyond the realm in which that definition applies. 494 U.S. at 953, N.4.

The first part of this *dicta* appears to confirm the Eleventh Circuit's interpretation of **United Housing.** The Court, however, makes clear that its statement is *dicta* because the issue was not before the Court. Further, the last part of the *dicta* indicates that the Court might re-consider the definition of "profits" in respect to investment contracts in an appropriate case. The present case presents the Court with such an opportunity.

C. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST FINDS NO SUPPORT IN THE STATE LAW ORIGINS OF THE CONCEPT OF "INVESTMENT CONTRACTS"

In **Howey**, the Court indicated that Congress had taken the definition of a security from previous state statutes. That definition, as were many sections of the originally proposed Securities Act of 1933, was drawn from the Uniform Sale of Securities Act adopted by the National Conference of Commissioners on Uniform State Laws. In turn, the Uniform Sale of Securities Act incorporated features of earlier state

securities. The words "investment contract" first appeared in the Arkansas Securities Act of 1913.[9]

Because of this incorporation of state law, the **Howey** Court indicated that it was appropriate to look to state law case for the definition of "investment contracts," since no definition was included in either the Securities Act of 1933 or the Uniform Sale of Securities Act. The Court said:

> By including an investment contract within the scope of §2(1) of the Securities Act, Congress was using a term the meaning of which had been crystalized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims.

Howey, 328 U.S. at 298.

The Court then proceeded to examine some eight state cases decided prior to the enactment of the Securities Act of 1933.[10] As noted above, SEC pointed out that two of these cases, **People v. White,** 12 P.2d 1078 (Cal. App. 1932) and **Stevens v. Liberty Packing Corp.**, 161 A. 193, 195 (N.J. Ch. 1932), involved a fixed income or "guaranteed" return. Clearly, these cases do not support the exclusion of fixed-return or interest-bearing instruments from coverage under investment contracts.

As the **Howey** Court noted, the first case to attempt to define "investment contract" was **State v. Gopher Tire &**

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[9]1913 Ark. Acts 214, at 904. See the Author's treatise, 12 Joseph C. Long, Blue Sky Law §1:16 (2002).

[10]For a discussion of those eight cases, see the Author's treatise, 12 Joseph C. Long, Blue Sky Law §1:17 (2002).

Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920). The court in **Gopher** concluded that an investment contract was a contract involving "[t]he placing of capital or laying out of money in a way intended to secure **income** or profit from its employment...." [Emphasis added.] The use of the word "income" clearly would cover the receipt of interest or a fixed-return payment. Subsequent Minnesota cases affirm this conclusion.

State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922), involved the sale of an interest in land under an installment plan. The contract provided that the investor could surrender his interest in the land and be paid a bonus of seventy dollars per each thousand invested over and above the return of his investment. The court found the arrangement to be an investment contract under the **Gopher** test. Five years later, **Webster v. U.S.I. Realty Co.**, 170 Minn. 360, 212 N.W. 806 (1927), a similar land sale contract with a cash out option which paid interest was found to be an investment contract. *See also* **Kerst v. Nelson**, 171 Minn. 191, 213 N.W. 904 (1927).

Examples of interest bearing or fixed-return contracts being held to be investment contracts was not confined to Minnesota. For example, both **Fidelity Inv. Ass'n v. Emmerson**, 318 Ill. 548, 149 N.E. 530 (1925) and **McCormick v. Shively**, 267 Ill. App. 99 (1932) involve such agreements.[11]

From these cases and other pre-1933 state cases, it becomes abundantly clear that the Eleventh Circuit's restriction on

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[11]In fact, the Illinois Act of that period defined investment contract. It indicated that a contract involving:

> a sum of money [to be paid] at a future date, either with or without interest, in consideration of a payment or payments made or contemplated to be made by such purchaser or holder, ... are hereinafter referred to as investment contracts.

Cahill's Revised Statutes 1931, Ch.12, ¶259(1).

"profits" does not find support in the early state cases. Investment contract, prior to 1933, involved the expectation of the receipt of **income** in the form of profits, interest, or the payment of a fixed return.

D. THE PUBLIC POLICY BEHIND THE SECURITIES ACT OF 1933 DOES NOT SUPPORT THE EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST

Probably the most important argument against adopting the Eleventh Circuit's exclusion of fixed-payments and interest from a "profit" comes from the purpose and public policy behind the Securities Act of 1933. The purpose of the Act was to ensure that the investing public had the necessary information to make an informed decision whether to purchase the security. The public policy behind the Act should be to define a definition of a "security" in such a way that all investors who need such information are covered by the Act, and those who do not are excluded. *Cf.* **SEC v. Ralston Purina Co.**, 346 U.S. 119 (1953).

The Court in **Howey** properly identified the category of investors who need the protection of the Act, when it said: "[A]ll the elements of a profit-seeking business venture are present here. **The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise."** *Id.* at 299. [Emphasis added.]

Put another way, a security is present when the capital providing function is separated from the management function. The investor supplies at least part of the capital. The promoter or a third party supplies the management and control of the operation. The investor needs to be supplied information about the company, its product, and the company's success in the marketing of the product. Further, the investor needs information about the people to whom he is entrusting his money.

Finally, the investor needs to be informed about his investment. Does it carry the right to vote in the entities affairs and to what extent? What return does the investment yield and does that yield vary, or is it fixed? Will this return be paid as long as the entity is solvent or is it dependent upon the profits of the enterprise? Where does the investment rank in bankruptcy and liquidation? What are the chances that investor will actually receive his return?

There are two types of investments where the investor does not need this information. As the above quoted language from **Howey** points out, the first example is where the investor actively engages in the operation or management of the enterprise. An example of this active participation is the general partnership where all partners exercise their statutory partnership rights to manage the partnership. Under this scenario, the investor, by participating in management, is in control of his own destiny. Further, the investor, by virtue of his participation, has access to the information necessary to make an informed investment decision.

The second type of investment is where the investment is totally passive. An example of this type of investment is where the investor, himself,[12] purchases a piece of raw land. He does not plan to develop the land or use it for agricultural purposes. The land is to remain idle. The investor hopes, however, that the land will appreciate in value. However, such appreciation is not related to anyone's concerted effort.

The above quoted language from **Howey** serve to eliminate the first situation where there is no need for investor protection. It indicates that there must be an investment with the expectation of a profit and the investor is passive. These are the

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[12]If he hires someone to exercise his special expertise in selecting the land, then an investment contract results because the selection process is the necessary active element.

first and third elements of the **Howey** test, investment with the expectation of a profit to come from the efforts of others.

The passive investment scenario is eliminated by the **Howey** common enterprise element. When properly construed, it requires nothing more than two people joining together to accomplish a common goal of making a profit for the investor. To accomplish this goal, someone other than the investor must actively generate the expected profits.

Thus, the **Howey** test is designed to meet the public policy of eliminating those persons who do not need the protection of the securities acts under "the investment contract" portion of the definition of a security. Or, as will be developed below, it identifies the elements of "securitiness" which should be applied to **all** parts of the definition.

In construing the various parts of the **Howey** definition, this public policy must be the pole star. No artificial element or requirement should be added which does not aid in identifying those people the Act was intended to cover.

A prime example of such an artificial test is the division over the meaning of "common enterprise." The Sixth and Seventh Circuits, based upon the facts of **Howey**, claim that there must be multiple investors. The Ninth Circuit requires the promoter or third party to share in the profits of the enterprise.

Neither of these requirements furthers the goal of identifying persons to be protected. A single investor buying what otherwise would be an investment contract needs the same protection as when two or more investors buy the same investment. Likewise, the investor who receives all the profits generated by the promoter or third party needs the protection of the Act, if he is passive, as does a similar investor who only receives part of the profits.

PIABA submits that the Eleventh Circuit's elimination of interest and fixed-returns from the definition of profit is merely another artificial restriction. The Court in **Reves** in the footnote quoted above recognized that for the purposes of promissory notes "profits" should include interest. The same is obviously true for bonds, debentures, and other evidences of indebtedness contained in the statutory definition.

The question then becomes whether there is something inherent in the nature of an "investment contract" that requires different treatment. PIABA submits that the answer to this question is "no."

PIABA believes the **Howey** test outlines the elements of "securitiness." PIABA also believes that these elements are found in all the enumerated terms in the definition of a security. Therefore, "profit" should not be treated differently under the "investment contract" portion of the definition than it is when dealing with other portions of the definitions such as notes, bonds, debentures, or other evidences of indebtedness. A "profit" for the purpose of identifying those persons needing the protection of the securities is a "profit" whether it takes the form of a dividend, interest, or payment under a fixed-return obligation.

The Eleventh Circuit, by excluding interests and payment under fixed-return obligations, has simply created another irrelevant artificial test which does not help accomplish the purpose and public policy behind the Securities Act of 1933. This Court should strongly reject such effort.

E. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE HOLDINGS IN MANY OTHER LOWER FEDERAL COURT DECISIONS

Two federal district courts, in addition to the trial court in the present case, **SEC v. ETS Payphones, Inc.,** 123 F. Supp.2d

1349 (N.D.Ga. 2000), rev'd ___F.3d___ (11th Cir. 2002), have held that payphone schemes similar to that in the present case are investment contracts. **SEC v. Phoenix Telecom, LLC**, 2000 U.S. Dist. LEXIS 22314 (N.D. Ga. Aug. 2, 2000) and **SEC v. Alpha Telecom, Inc.,** 187 F. Supp.2d 1250 (D. Ore. 2002).

Since the **United Housing** decision, both the Third and the Ninth Circuits have rejected the exclusion of interest or fixed payments from the **Howey** definition of profit. In doing so, they have held that fixed-return or debt securities can be investment contracts.

The Third Circuit in **SEC v. Infinity Group Co.**, 212 F.3d 180, 189 (3d Cir. 2000), stated "the definition of security does not turn on whether the investor receives a variable or fixed rate of return." Similarly, in **United States v. Carman**, 577 F.2d 556, 563 (9th Cir. 1978), the court rejected the defendant's argument that the student loans involved in that case were not investment contracts. The contracts provided that the return on these student loans carry a fixed interest return. Further, the interest was guaranteed by the federal government. The Ninth Circuit held these contracts to be investment contracts. *See also* **United States v. Farris**, 614 F.2d 634, 641 (9th Cir.1979)(promissory notes on real estate) and **United States v. Jones**, 712 F.2d 1316 (9th Cir.), *cert. denied*, 464 U.S. 986 (1983)(sale and lease back of semi-trailer).

Finally, the Eleventh Circuit decision in the present case is in conflict with other binding decisions by the Fifth Circuit prior to the creation of the Eleventh Circuit. In **Bonner v. City of Prichard**, 661 F.2d 1206 (11th Cir. 1981)(en banc), the Eleventh Circuit adopted as precedent all decisions of the former Fifth Circuit decided prior to October 1, 1981.

Immediately before the creation of the Eleventh Circuit, the Fifth Circuit in **Meason v. Bank of Miami**, 652 F.2d 542, 550, N.17 (5th Cir. 1981) recognizing that this Court had never

had a note case before it, rejected the district court's holding that an investment was not a security, merely because the investor received a fixed-return on the investment.[13] It stated the definition of "profits" in the **United Housing** case "seems to us to be dubious value in [the note] context." Similarly, in **Bell v. Health-Mor, Inc.**, 549 F.2d 342 (5th Cir. 1977), the Fifth Circuit found an investment contract where the purchaser of a vacuum cleaner was to receive ten dollars for every referral made. The ten dollars was payable, if the referral allowed a demonstration of the vacuum **whether or not a sale was made.**

F. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY THE SEC

As the SEC notes in its Brief Seeking Certiorari, 23-24, and its brief on the merits, both the exclusion of interest and fixed payments from the definition of "profit" runs contrary to the long standing position of the SEC in its administrative actions. *See e.g.*, **In re Abbett, Sommer & Co.**, 44 S.E.C. 104, 1969 WL 95369 (1969) and **In re Union Home Loans,** 26 S.E.C. Dkt 1517, 1982 WL 522493 (Dec. 16, 1982).

Further, the Commission has argued in its enforcement cases involving "Prime Bank" and various other schemes that such schemes are investment contracts. This position is taken in spite of the fact that most of the schemes provide the investor with a guaranteed rate of return. *See also* **SEC v. Herula**, C.A. No. 02-154-ML (D. R.I. June 20, 2003)(Prime Bank); **SEC v. Yoder**, No. #:03-CV-0418AF (N.D. Ind., filed June 19, 2003);

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[13]Meason indicates other courts have not accepted the idea that a fixed return disqualifies the finding of an investment contract., citing Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); SEC v. Nat'l Executive Planners, Ltd., 503 F.Supp. 1066 (M.D.N.C. 1980); and SEC v. Weeks Sec. Inc., 483 F.Supp. 1239, 1243-1244 (S.D. Tenn. 1980).

SEC v. Capital Holdings, L.L.C., CA No. 03-RB-0923 (D. Colo., filed May 21, 2003).

This argument appears to have been accepted by the courts. For example, **SEC v. SG, Ltd.**, 265 F.3d 42, 54 (1st Cir. 2001) involved virtual reality shares. Relying heavily upon **Joiner,** the First Circuit found the shares to be investment contracts. In discussing the "profits" element of **Howey**, the court noted: "SG flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% and annual returns of 25%. In our view, these profit-related guarantees constitutes not-very-subtle form of economic inducement...."

G. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY MANY STATE COURTS

Many state courts have rejected the idea that fixed fee agreements and debt securities can not be investment contracts. These courts have construed the definition of "investment contracts" under the state securities acts to cover both fixed payment agreements and promissory notes. *See e.g.*, **State v. Gerisch**, 49 P.3d 392 (Idaho 2002); **Mosley v. State**, 253 Ga. App. 710, 560 S.E.2d 305 (2002); **Bayhi v. State**, 629 So.2d 782 (Ala. Crim. App. 1993); **State v. Philips**, 108 Wash.2d 627, 741 P.2d 24 (1987), all promissory note cases. *See also* **Manns v. Skolnik**, 666 N.E.2d 1236 (Ind. App. 1996)(a contractual obligation to pay fixed return case). The most recent of this series, **Rasch v. State**, 579 S.E.2d 817 (Ga. App. 2003), was decided while the petition for certiorari was pending before this Court. More specifically, two state cases, **King v. Pope**, 91 S.W.3d 314 (Tenn. 2002)(a payphone case with fixed monthly payments similar to ETS), and **Szpunar v. State**, 783 N.E.2d 1213 (Ind.

App. 2003)(another payphone scheme), have held that payphone sales involve the sale of an investment contract.

Several of these state decisions speak directly to the question of whether fixed fees or interest can qualify as "profits." In **Payable Accounting Corp. v. McKinley**, 667 P.2d 15, 19 (Utah 1983), the court said "the critical factor is not whether the rate of return is fixed, but whether the 'investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise.'"

In **People v. Figueroa**, 41 Cal. 3d 714, 715 P.2d 680, 224 Cal. Rptr. 7119 (1986)(en banc) also addressed the issue of fixed payments, saying:

> Many "investment contracts"...contemplate both a variable and a fixed return. The investment contracts in [**People v. Coster**, 151 Cal. App.3d 1188, 199 Cal. Rptr. 253 (App. 1983)], for example purported to give the investor a 20 percent "fixed" return on principal and 1 percent of the **gross** company income. [Citation omitted.] Both kinds of return, as well as a recoupment of principal depended on the success of the business.... It would be illogical to [to exclude] a promissory note transaction simply because the promised return ... is to take the form of interest at a "fixed" rate. Id. at 740, 715 P.2d at 698, 224 Cal. Rptr. at 737. [Emphasis added.]

H. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY STATE SECURITIES AGENCIES

Likewise, the state securities agencies themselves have rejected the idea that an instrument calling for either the payment

of interest or a fixed fee can not be investment contracts. As noted in Point I, at least 18 state securities agencies have brought administrative enforcement actions against ETS. New York has also brought an action against another company offering a similar fixed return plan. **State of New York v. Justin**, 237 F. Supp.2d 368 (W.D.N.Y. 2002). At least two of these state ETS cases were contested cases, and both were decided after the Eleventh Circuit's opinion in the present case. **Both** rejected the Eleventh Circuit's position. In **Stigall v. Sec. of State,** Case No:EN-18727 Final Decision (Sept. 6, 2002), slip op. at 13. the Georgia Commissioner said:

> The Commissioner rejects the Eleventh Circuit's analysis of the third element of **Howey** as being inextricably intertwined with its narrow view of "profits." ... [T]he fact that there is a contractual guarantee of payment which might be satisfied from the capital of the enterprise is as irrelevant in this case as it would be in a case involving a promissory note. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."

Likewise, in **Department of Banking and Finance v. Mehl**, DOAH Case No. 02-0526, 2002 WL 31452438 (Fla. Sec. Div., Final Order, Oct. 17, 2002), the Florida Comptroller rejected the Eleventh Circuit approach under the Act. The Comptroller said "Florida law does not use such a narrow construction of 'profits,' it has not distinguished between fixed or variable returns to the investor." As outlined in Point I, sixteen other state securities agencies have also taken action against ETS under the investment contract analysis. A number of new orders

have been entered during this Court's deliberation whether to grant certiorari.[14]

In summary, there is no basis in the language of the Securities Act, the prior case law from this Court, the history of the concept of "investment contract," or the public policy and purpose behind the Act to support the Eleventh Circuit's exclusion of interest and payment under a fixed-return contract from the definition of "profits" under the **Howey** test. Further, such limitation runs contrary to the holdings of other federal courts, the SEC, the state courts, and the state securities agencies which have held that interest may constitute a profit for investment contracts purposes.

POINT II

IN REVERSING THE ELEVENTH CIRCUIT, THE COURT SHOULD CONDUCT AN OVERALL REVIEW OF "SECURITINESS"

Assuming that the Court is willing to overturn the Eleventh Circuit's decision, PIABA suggests that the Court can accomplish the result of assuring that interest and payments under fixed-return contracts are included in the definition of "profits" in either of two ways. The easiest and simplest approach would be to rule that interest or any fixed income can be considered a "profit" under the "profit" element of the **Howey** test. The second way is for the Court to use this case as a vehicle for a broad rethinking of the elements of an "investment contract" and of a "security" in general. PIABA urges the Court to follow the second choice.

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[14] See e.g., In re Mack, 2003 WL 21269563 (Ohio Dept.Comm., May 30, 2003); In re Ray, 2003 WL 21269561 (Ohio Dept.Comm., May 22, 2003); and In re Ellsworth, 2003 WL 21207816 (Mo.Div. Sec., April 29, 2003).

A. THE COURT SHOULD NOT SIMPLY REDEFINE "PROFITS" TO INCLUDE INTEREST AND FIXED PAYMENTS

As noted above, the simplest way to resolve the present case is to reverse the Eleventh Circuit. It can, at the same time, disaffirm the *dicta* in both **United Housing** and **Reves.** Then, the Court can make crystal clear that "profits" under **Howey** includes both interest bearing agreements and fixed-return contracts. In so doing, the Court would bring the definition of "profits" under the investment contract portion of the definition in line with the definition "profits" used in the **Reves** case for promissory notes.

While this approach will accomplish the appropriate result and is attractive because of its simplicity, PIABA would urge the Court not to limit its pronouncement in this way. This approach is merely applying another band-aid to an area where prior case law by this Court, as well as the other federal courts, is in serious confusion. This confusion has resulted in losing sight of the purpose of, and policy goals behind the Securities Acts.

B. THE COURT SHOULD UNDERTAKE A RECONSIDERATION OF THE WHOLE CONCEPT OF WHAT IS A SECURITY AND IDENTIFY THE ELEMENTS OF "SECURITINESS"

PIABA urges the Court to use the present case as a vehicle for a broad re-thinking of the elements of an investment contract and of a security in general. It has been almost sixty years since the landmark decision in **SEC v. W.J. Howey Co.** During this period, the Court has dealt with the definition of a security as well as the definition of an investment contract on a piece-meal basis. This approach has resulted in a great of uncertainty in an area where predictability is extremely important.

PIABA believes that time is overdue for the Court to take the time to re-think the entire concept of what is a security. In

doing so, the Court can harmonize its various pronouncements and develop a single logical approach to this issue. The result should be a definition of investment contracts, and "securitiness" in general, which is consistent with the intent of Congress in passing the Securities Act of 1933.

In performing this task, the Court should strive to eliminate a number of artificial tests which have grown up under various elements of the **Howey** test. These artificial or mechanical tests do not help identify the people which Congress intended to have the protection of the Securities Act. These tests have developed largely because of the imprecision of the Court in its past pronouncements. These tests merely burden the definition of investment contracts, and securities in general, with restrictions or limitations which has no relevance to defining that which Congress sought to regulate by passing the Securities Act of 1933.

This Court, in many other areas, has sought to return to the original intent of Congress as determined by the language of the statute itself, its legislative history, and historical development as gleaned from similar statutes which Congress sought to use as a drafting model. The Court needs to undertake such a re-analysis in the securities area and develop, in a consistent and rational way, what are the elements of "securitiness."

PIABA believes the Court in **Howey** long ago identified the four proper elements of a security. As discussed above in Point ID, these are an investment in active enterprises motivated by the expectation of a profit or return to the investor where some one other than the investor will perform the managerial and entrepreneurial functions necessary to generate that profit or return.

The investment should not be limited to money, but should include services performed or the use of property given to the enterprise.

The enterprise must be actively doing something to generate the expected profit. Further, it should make no difference whether there is only one investor or many. Likewise, it is irrelevant whether the promoter or third person participates in the profits or return.

The profits or return should include interest, dividends, and fixed payments. Further, it should not be limited to the payment of money, but should include the distribution of other securities or property.

Finally, to be excluded under the efforts of others test, the right to participate in management must come from the ownership of the securities and not the holding of an office such as an officer or director of a corporation. Also, the right to participate in management must be a right to directly participate in the management of the enterprise, and not be indirect management as in the case of election of the directors of a corporation.

To confirm these elements of "securitiness", the Court should apply the above elements to stock in a corporation. The Court in **Landreth Timber Co. v. Landreth**, 471 U.S. 681, 105 S.Ct. 2297 (1985), held that stock was the quid essential example of a security.

To obtain stock in a corporation, the shareholder must invest money, property, or services in the corporation. The corporation is actively doing something, such as manufacturing goods or performing services, to generate a profit. The investor has made his investment in the corporation in the expectation that he will receive a profit in the form of dividends or an appreciation in the value of his stock.

Finally, his stock ownership may or may not give him the right to participate in the election of the board of directors and on certain extraordinary events such as merger or sale of assets. Yet this right is a derivative right. It does not allow the shareholder to direct the day-to-day operations, merely elect the directors who

are responsible for such operations. Stock then has all the essential elements of "securitiness" identified by **Howey.**

A similar result will be reached, if the elements are applied to bonds and debentures. The active enterprise element will eliminate from coverage under the Act of those notes and evidences of indebtedness used to fund the purchase of car, boat, or home where the purchaser is consuming the goods for his own personal use rather than employing them in an active enterprise to generate a profit.

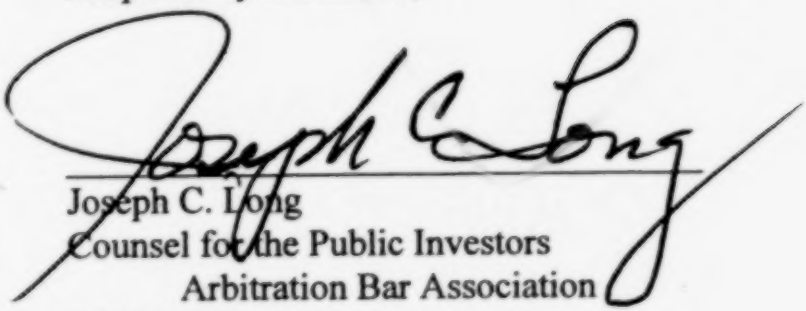
After over ninety years of securities regulation, it is time to positively identify the elements of the interests to be regulated rather than relying upon a laundry list of items which might or might not carry the elements of a security. PIABA urges the Court to use the present case to undertake such an identification task.

SUMMARY

Based upon the above outlined cases and agreements, PIABA urges the Court to reverse the Eleventh Circuit and find the ETS interest to be investment contracts. In doing so, PIABA urges the Court to reject the idea that a "profit" under the **Howey** test can not be interest or the payment of a fixed return. Finally, PIABA urges the Court to undertake a re-thinking of the area of what is a security. In doing so, the Court should isolate the elements of "securitiness" common to all securities. PIABA believes that these elements are found in the **Howey** test as interpreted above.

Dated: June 26, 2003
Norman, OK 73072

Respectfully submitted,



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IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES E. EDWARDS,
Respondent.

On a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE*, IN SUPPORT OF THE SECURITIES AND EXCHANGE COMMISSION

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QUESTIONS PRESENTED

1. Whether a return on an investment should be excluded from the meaning of "profits" under the *Howey* test for investment contracts merely because the promoter of the investment offers a fixed rate of return.

2. Whether a return on an investment, which is in fact wholly dependent upon the efforts of others, should nevertheless be viewed as not "derived from the efforts of others" under *Howey* merely because the promoter contractually promises or guarantees the return.

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IN THE

Supreme Court of the United States

No. 02-1196

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES E. EDWARDS,
Respondent.

On a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE*, IN SUPPORT OF THE SECURITIES AND EXCHANGE COMMISSION

INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of the state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.[1]

[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity,

The members of NASAA are responsible for administering state securities laws and regulations. Their principal activities include licensing, registration, enforcement, and investor education. State securities regulators also strive to increase uniformity in the securities laws, as enacted and as interpreted. NASAA supports the work of its members in all of these endeavors, for the ultimate purpose of protecting investors from fraud and abuse.

The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels. First, it removes the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse. Although it is to be expected that state regulation of these investments will continue, eliminating the SEC's jurisdiction over such offerings will at a minimum increase the burden on state regulators and heighten the risk that investors will fall victim to these schemes. NASAA therefore has an interest in seeking the reversal of the appellate court's decision and the restoration of federal regulation of these products.

Second, the appellate court's decision substantially narrows the federal definition of "investment contract" under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The Eleventh Circuit held that investments offering either fixed or contractually guaranteed returns do not qualify as investment contracts. This unsupported interpretation of *Howey* creates loopholes that unscrupulous promoters undoubtedly will seek to exploit in the future as they invent new ways to defraud the investing public. NASAA has an interest in helping to

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other than NASAA, its members, or its counsel, made any monetary contribution to the preparation or submission of the brief. Pursuant to Sup. Ct. R. 37.3, NASAA further represents that both parties to this appeal consented to the filing of this *amicus* brief. Copies of their written consents are being filed with this brief.

prevent this potentially far-reaching impact of the appellate court's decision.

Finally, the appellate court has set a precedent that, if affirmed by this Court, will profoundly and adversely affect the evolution of state securities law to the detriment of investors. State courts and administrative agencies often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in helping to ensure that the appellate court's decision does not weaken state securities law in this way.

SUMMARY OF THE ARGUMENT

The appellate court's decision should be reversed for two reasons. First, the narrow interpretation of *Howey* adopted by the Eleventh Circuit will harm investors. If affirmed, the ruling will expose thousands of everyday citizens throughout the country to a heightened risk of fraud and abuse at the hands of pay phone promoters and others selling a variety of sale and leaseback investments no longer subject to federal regulation as securities. More broadly, the decision provides an unfortunate blueprint to unscrupulous promoters who easily will devise new schemes that fall outside the appellate court's narrow definition of an investment contract. In its most far-reaching impact, the decision will have a corrosive effect not only on federal securities law, but on state securities law as well. Federal courts in general exert an important influence over state courts and administrative tribunals in the area of securities regulation, and the decisions of this Court have by far the greatest impact. It is therefore essential that this Court reject the appellate court's decision so that state securities law is not undermined.

Second, the appellate court's decision should be reversed because it is legally untenable. The ruling conflicts with the plain meaning and intent of the securities laws, the vast weight of federal and state court decisions, and long-standing

administrative agency interpretation. There is no persuasive rationale for the Eleventh Circuit's narrow construction of the term "investment contract," nor is there any reason for excusing Edwards or any similar promoter from complying with the licensing, registration, and disclosure requirements imposed under the securities laws. Unless the pay phone investments at issue in this case continue to be fully regulated as securities at both the federal and state level, investors will suffer. Accordingly, the Eleventh Circuit's decision should be reversed.

ARGUMENT

I. THE APPELLATE COURT'S DECISION OPENS AN ENORMOUS LOOPHOLE IN SECURITIES LAW, WHICH EXPOSES INVESTORS TO A HEIGHTENED RISK OF FRAUD AND ABUSE

By holding that the ETS pay phone investment is not a security, the appellate court has placed investors at risk. Over the past decade, there have been widespread abuses in the marketing of pay phone schemes, and as a consequence, thousands of investors have lost money. Continued regulation of these and similar products under both federal and state securities law is essential to limit the financial harm they inflict upon investors.

A. Scope of the Problem

The pattern of abuses in the marketing of pay phone sale and leaseback programs is well documented. Over the years, state securities regulators across the country have initiated scores of administrative and civil actions against pay phone sale and leaseback companies and their agents, including ETS, Alpha Telcom, Phoenix Telecom, QCI, and others.[2]

[2] The investments sold by these companies are essentially the same. Alpha Telcom offered investors 30% of adjusted gross revenues, but with a guaranteed minimum that equated to a 14% return. *See, e.g., In re Alpha Telcom,* No. 99-07-0220, 2002 WL 459704, *3 (Wash. Sec. Div. Mar. 13, 2002).

The record in this case, for example, includes three cease and desist orders issued against ETS by state securities regulators in Kansas, North Carolina, and Rhode Island, all arising from the sale of unregistered securities and, in the action by North Carolina, fraudulent sales practices as well. *See* Exs. 9, 10, 11. Other cases abound.[3]

The scope of the problem was highlighted in March 2001, when NASAA announced the results of a crackdown by securities regulators in 25 states and the District of Columbia against individuals and companies selling pay phone sale and leaseback investments in violation of state securities law. *See* NASAA, *State Securities Cops Announce Actions Against Sellers of Payphone Schemes; Losses Estimated at $76 Million So Far,* March 13, 2001, *available at* www.nasaa.org, "Archived Top Stories." Nearly 4,500 people, most of them elderly, were reported to have lost $76 million investing in these schemes, which were described as "the tip of a very large iceberg." *Id.* As a further part of its continuing effort to warn the investing public about illegal and fraudulent investments, NASAA repeatedly has included sale and

[3] A sampling of enforcement actions against pay phone programs includes the following cases, in addition to the actions discussed elsewhere in the brief: *In re Sommer,* No. S-03489A-03-0000 (Ariz. Corp. Comm'n Feb. 25, 2003), *available at* http://www.ccsd.cc.state.az.us/enforcement/Actions/2003/feb25-03.pdf; *In re Nat'l Communics. Mktg., Inc.*, No. A-02-0037 (Ore. Div. of Fin. & Corp. Secs. Oct. 2002); *In re Fecht*, No. 02-12, 2002 WL 927153 (Tx. St. Sec. Bd. Apr. 24, 2002); *In re Alpha Telcom, Inc.,* No. 01-36-S, 2001 WL 1650906 (Ark. Sec. Dep't Sept. 5, 2001); *In re Nat'l Communics. Mktg., Inc.,* No. 99-06-0176, 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001); *Dep't of Banking & Fin. v. Paytel Communic. Sys., Inc.,* No. 98-1626, 2000 WL 347485 (Fla. Div. of Admin. Hr'gs Mar. 16, 2000); *In re Alpha Telcom, Inc.,* No. S-99225 (EX), 1999 WL 1083919 (Wisc. Comm'r of Sec. Nov. 24, 1999); *In re Phoenix Telecom LLC,* No. 2-16-99-038 (Mont. Sec. Dep't Oct. 29, 1999).

leaseback schemes in its annual review of the "Top 10" scams to be avoided. *See* NASAA, *"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

The U.S. Securities and Exchange Commission (SEC) also has taken aggressive enforcement action against these illegal enterprises. Examples include this case against ETS as well as four injunctive actions in federal district court in Florida and Georgia, in which the SEC sought millions of dollars in disgorgement and other relief against four pay phone companies and their agents. *SEC v. Phoenix Telecom,* No. 100-CV-1970-JTC (N.D. Ga.), 2001 WL 874314 (SEC Release No. 17089, Aug. 3, 2001); *SEC v. Linktel Communics., Inc.*, No. 100-CV-3169-WBH (N.D. Ga.), 2000 WL 1773106 (SEC Release No. 16816, Dec. 4, 2000); *SEC v. Levine*, No. 94-6898-CIV-ZLOCH (S.D. Fla.), 1994 WL 559076 (SEC Release No. 14279, Sept. 30, 1994); *SEC v. Haje*, No. 92-510-CIV-J20 (M.D. Fla.), 1993 WL 347148 (SEC Release No. 13772, Sept. 3, 1993).

The violations common to these operations include the sale of unregistered securities in the form of investment contracts by unlicensed agents making fraudulent misrepresentations and omissions concerning the risk of loss, the likelihood of profits, the financial condition of the enterprise, and the promoter's disciplinary history. *See generally SEC v. Alpha Telcom, Inc.,* No. CV 01-1283 PA, 2002 WL 193093 (D. Or. Feb. 7, 2002); *SEC v. Phoenix Telecom, L.L.C.,* No. 1:00-CV-1970-JTC, 2000 WL 33956119 (N.D. Ga. Aug. 2, 2000).

These violations of the securities laws have caused enormous financial injury to public investors. An enforcement action brought by the state securities regulator in Florida against two individuals who sold the ETS program illustrates the point. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *24-25 (Fla. Div. Admin. Hr'gs

July 16, 2002) (Recommended Order), *aff'd, Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order). The administrative law judge in *Mehl* concluded that the ETS pay phone program was an investment contract, bearing "all the indicia of a Ponzi scheme," which the respondents had sold, along with other illegal offerings, in violation of the licensing and registrations provisions of the Florida securities act. *Id.* at *16, 22-24. The ALJ imposed multi-million dollar fines against each of the respondents, with this observation: "These fines are fair for the enormity of the harm caused by Respondents in this case. Even if acting only negligently, Respondents have left many persons in irreversible financial ruin for the remaining years of their lives." *Id.* at *24.

B. Benefits of Regulation

The SEC and state securities regulators have long viewed pay phone sale and leaseback schemes as securities and have regulated them as such. Accordingly, investors have been receiving important protections as intended by Congress and the state legislatures. First, the securities themselves must be registered so that material information about the offering is made available to prospective investors before they part with their money. *See* 15 U.S.C. §§ 77f, 77g, 77j; Unif. Sec. Act of 1956 § 301 (registration of securities); *see also In re Nat'l Communics. Mktg., Inc.,* No. 99E039 (Ka. Sept. 25, 1998) (Cease and Desist Order), Ex. 10, at 5 (due to lack of registration, Kansas residents are not provided with the investment information required by the Kansas Securities Act).[4] Second, those who sell securities must be tested and

[4] The Uniform Securities Act of 1956 is the predominant model for states securities laws. It has been adopted by 34 states, with some individual variations. *See* Chart showing states adopting Unif. Sec. Act of 1956, *available at* www.law.cornell.edu/uniform/vol7.html#secur. Even those states that have passed their own securities laws have similar regulatory requirements and remedies.

licensed to help ensure they have the knowledge and fitness to accept investor funds and render investment advice. *See* 15 U.S.C. § 78o; Unif. Sec. Act of 1956 § 201 (licensing of industry participants); *see also In re Communics. Mktg. Assocs., Inc,* NO. DBR 00-114 (R.I. Mar. 28, 2000) (Cease and Desist Order), Ex. 11 at 3 (respondent's failure to be licensed exacerbates likelihood that untrained, inexperienced salespersons will defraud or take advantage of investors).

Third, the securities laws impose stiff civil and criminal penalties as a deterrent against violations of the licensing, registration, and anti-fraud provisions. *See* 15 U.S.C. §§ 77q, 77t, 77x, 78f, 78j, 78u; Unif. Sec. Act of 1956 §§ 101, 408-410 (civil and criminal penalties). Finally, the securities laws give regulators the authority to seek important remedial measures, including injunctions, disgorgement, and restitution. *See id.* (injunctive relief and civil liabilities); *see also In re ETS Payphones, Inc.,* No. 01-0056CD, 2002 WL 1586379, at *1 (Ind. Sec. Div. June 7, 2002) (ETS salesman ordered to disgorge commissions to injured investor pursuant to consent agreement).

With these requirements and remedies at their disposal, regulators can deter violations in the first instance, enjoin violations in progress, and attempt to recover ill-gotten gains from those who have profited at the expense of investors. All of these provisions have played an important role in limiting the harm that illegal pay phone schemes and other investment contracts have inflicted on the investing public.

C. Future Impact

The appellate court's decision in this case threatens harm to investors on multiple levels by stripping away these protections. If allowed to stand, the decision's most immediate impact will be to tie the SEC's hands with respect to pay phone sale and leaseback programs, as well as all other investment contracts that have been structured to provide

fixed or guaranteed returns.[5] While indications are that state securities regulators will continue to enforce their laws against promoters of these products, sidelining the SEC will increase the burden on these state regulators and inevitably expose investors to a heightened risk of fraud and abuse.

The appellate court's decision also threatens a much broader harm by fundamentally narrowing the application of the *Howey* investment contract test. "Guaranteed" and "fixed returns" often are meaningless labels that promoters attach to their investment contracts to attract investors. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) (observing that the guarantee accompanying ETS contracts was "nothing more than the promoter's means of lulling the investor into a feeling of security and thereby parting him from his money"). Under the court's decision, these same terms—easily inserted into a contract—will serve as a convenient shield against regulation of investment contracts as securities. Regulators can now expect to see the emergence of a wide variety of new and fraudulent investment schemes specifically designed to benefit from the loophole created by the appellate court.

Finally, the court's decision will undermine state, as well as federal, securities regulation. State courts and state administrative agencies often consult federal decisions for guidance on securities issues. *See, e.g., Payable Accounting Corp. v. McKinley*, 667 P.2d 15, 17 (Utah 1983) (states frequently rely on federal case law in interpreting state securities acts). As observed by the Florida Department of

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[5] ATM machines and Internet kiosks are examples of other products that have been the subject of illegal investment schemes similar to the pay phone sale and leaseback programs. *See* NASAA, *"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

Banking and Finance, "In some instances, state and federal securities laws appear as mirror images. Both, for example, have the same definition for the term 'security.' For these reasons, in the absence of state decisional law, state courts will look to federal court decisions for guidance." *Dep't of Banking & Fin. v. Mehl*, 2002 WL 31452438, at *2. Some state securities laws expressly provide that their interpretation should be coordinated with the interpretation and administration of federal securities law. *See State v. Gertsch*, 49 P.3d 392, 396 (Idaho 2002).

The appellate court's decision has prompted numerous pay phone promoters to challenge prior rulings against them in state enforcement actions. These arguments have surfaced in states within the Eleventh Circuit and elsewhere. In *Iowa ex rel. Miller v. Pace*, Equity No. LA26445 (Iowa D. Ct., Warren County Sept. 4, 2002), *appeal docketed*, No. 02-1726 (Iowa, Oct. 28, 2002), the Iowa District Court found that ETS pay phone transactions were investment contracts under *Howey,* and ordered the defendant to make restitution of over $300,000 for fraud in the sale of unregistered securities. *Id.* at 16, 23-24, 27-28. The defendant has appealed the state district court's order to the Iowa Supreme Court, and is relying heavily on the Eleventh Circuit's opinion in this case for the proposition that the ETS offerings are not investment contracts as a matter of law. *See* Appellant's Proof Br. at 28-32, *Iowa ex rel. Miller v. Pace,* No. 02-1726 (Iowa Jan. 21, 2003). The appeal is pending.

In *Garvin v. Sec'y of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hr'gs Aug. 28, 2002) (Order on Reconsideration), an administrative law judge with the Georgia Office of Administrative Hearings ruled that the ETS pay phone investment was a security, issued a cease and desist order against further offerings of the investment, and imposed a fine against the respondent for

selling unregistered securities. The respondent filed a petition for review in state court, relying in part on the Eleventh Circuit's opinion in this case. *See* Aff. of Charles R.T. O'Kelley, attached as Ex. B to Pet'r Br. in Support of Pet. for Judicial Review, at 7-8, *Garvin v. Sec'y of State,* No. 2002 CV 60273 (Ga. Super. Ct., Fulton County Dec. 16, 2002). On March 17, 2003, the Georgia Superior Court ruled against the respondent, expressly rejecting the Eleventh Circuit's analysis and affirming that the ETS program is an investment contract. *See Garvin v. Sec'y of State,* No. 2002 CV 60273 (Ga. Sup. Ct., Fulton County Mar. 17, 2003) (Final Order). However, on April 14, 2003, the respondent filed an application in the Georgia Court of Appeals for a discretionary appeal, relying again on the Eleventh Circuit's decision in this case. *See Garvin v. Sec'y of State,* No. 2002 CV 60273, Application No. A03D0309, at 17, 20 (Ga. Ct. App. Apr. 14, 2003). That application was granted on April 29, 2003, and the appeal is pending. *See id.* (Order Granting Applic. for Discr. App.).

The Eleventh Circuit's decision also has been cited in defense of investments other than pay phone sale and leaseback programs. In *In re Yucatan Resorts,* No. 2002-10-33, 2002 WL 31971658, at *1-2 (Pa. Sec. Comm'n Oct. 22, 2002) (Summary Order to Cease and Desist), the Pennsylvania Securities Commission named the respondents in a summary cease and desist order for selling unregistered securities in the form of a vacation resort leasing program. The program offered an annual return of 9%-11%, and featured the services of a third-party agent to handle leasing of the resort units for investors. *Id* at *1. On January 22, 2003, the respondents filed a request to vacate the order, and a motion for summary judgment in the alternative, relying in part on the Eleventh Circuit's ruling. *See* Resp't Req. to Vacate Cease and Desist Order or in the Alternative, Mot. for Summ. J. and Br. in Support Thereof, at 11-14, *In re Yucatan*

Resorts, No. 2002-10-33 (Pa. Sec. Comm'n Jan. 22, 2003). That request is pending.[6]

The influence of the Eleventh Circuit's decision has not been confined to courts and administrative agencies. Evidently as a direct result of the court's ruling, a bill was introduced in the Colorado legislature that would have amended the definition of a security in that state to *exclude* leaseback arrangements involving "a contractually fixed and guaranteed rate of return." *See* House Bill 1311, 1st Sess. (Colo. 2003).[7] This bill is particularly significant because Colorado is among the states where both state and federal regulators have taken aggressive enforcement action against pay phone promoters. *See Joseph v. Geier,* No. 01 CV 1151 (Colo. D. Ct., Denver County Jan. 30, 2003) (Order on Motions for Summary Judgment) (Phoenix Telecom pay phone program held to be investment contract); *SEC v. Quarter Call, Inc.,* No. 94Z-1227 (D. Colo.), 1996 WL 635380 (SEC Release No. 15145, Nov. 4, 1996) (action against now bankrupt pay phone company QCI, finding that defendants obtained over $9 million from 520 investors in fraudulent sales of pay phone investments). Although the bill did not become law, it nevertheless was a

[6] On May 2, 2003, the Pennsylvania Securities Commission was forced to seek a preliminary injunction against Yucatan in the Commonwealth Court of Pennsylvania, to address violations of the summary cease and desist order and to enforce a lawfully issued subpoena. *See Penn. Sec. Comm'n v. Yucatan Resorts S.A.,* No. 277 M.D. 2003 (Pa. Commw. Ct. June 5, 2003) (Opinion and Order). On June 5, 2003, the court granted the requested relief but left the core legal issue—whether the Yucatan offering is a security—to be resolved in the administrative proceeding. *Id.*

[7] *Available at* http://www.leg.state.co.us/2003a/inetcbill.nsf/fsbcont/1777905CD8404C8187256CC50077A764?Open&file=1311_01.pdf.

troubling attempt to curtail state securities regulation using the Eleventh Circuit's decision as a justification.[8]

These examples illustrate the potentially far-reaching impact that this case may have on state securities regulation and ultimately on public investors. Although the state courts and administrative tribunals that have had occasion to address the Eleventh Circuit's decision thus far have consistently rejected it,[9] the decision of this Court undoubtedly will have a more profound influence on the states' interpretation of the *Howey* test in pending and future cases. To prevent the erosion of state securities regulation, and to restore the SEC's regulatory jurisdiction to full strength, this Court should reverse the decision of the appellate court.

II. THE APPELLATE COURT'S DECISION CONFLICTS WITH THE PLAIN MEANING AND INTENT OF THE SECURITIES LAWS, THE VAST WEIGHT OF DECISIONAL AUTHORITY, AND THE UNDERLYING RATIONALE FOR THE INVESTMENT CONTRACT DEFINITION

The appellate court held that because the returns promised by ETS were at a fixed rate, they could not be classified as a participation in earnings, and therefore could not be

[8] Information about the progress of the bill is available at the following website: http://www.leg.state.co.us/2003a/inetcbill.nsf/Frameset?ReadForm&viewname=3&.

[9] Even where repudiated, the Eleventh Circuit's decision has been watched with interest at the state level. As observed by the Florida Department of Banking and Finance in *Mehl,* "even if the states were bound by the Eleventh Circuit's decision, this decision, as a matter of law, is not final. The SEC has petitioned the [Eleventh Circuit] for rehearing en banc." *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *4 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order).

considered profits for purposes of defining an "investment contract" under *Howey* and *United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 851-53 (1975). *See SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284-85. As an alternative basis for its decision, the court also held that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *Id.* at 1285. Each of these rulings conflicts with the plain meaning and legislative intent of the securities laws, federal and state court precedents, and administrative interpretations that federal and state regulators have been applying for years. The court's rulings furthermore lack a persuasive rationale under the securities laws.

A. The Appellate Court's Interpretation of "Profits" Is Unduly Narrow

1. Statutory Language and Legislative Intent

The appellate court's holding that fixed returns do not satisfy the "profits" test for investment contracts is inconsistent with a statutory analysis. As argued by the SEC in its Petition for a Writ of Certiorari, the words "investment contract," "income," and "profit" all encompass fixed as well as variable rates of return. *See* Petition for a Writ of Certiorari, at 10-11. The appellate court's restrictive interpretation of the term "investment contract" is inconsistent with the plain meaning of the statutory language chosen by Congress.

Legislative intent supports this reading of the statute. Congress intended to define the term "security" broadly in order to eliminate serious abuses in the securities markets. *See, e.g., Reves v. Ernst & Young,* 494 U.S. 56, 60 (1990); *United Hous. Found., Inc. v. Forman,* 421 U.S. at 847-48. The term "investment contract" was added as a catchall provision to ensure that the statute would cover not just the items specifically listed, such as stocks and bonds, but "virtually any instrument that might be sold as an investment." *See Reves,* 494 U.S. at 61; *SEC v. C. M. Joiner Leasing Corp.,* 320 U.S. 344, 351 (1943). Of course, many of the instruments enumerated in the definition of a security involve fixed returns, promises, and even guarantees. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10). As a catchall term, the reference to "investment contract" deserves an interpretation broad enough to include these traditional characteristics of securities, along with features outside the mainstream. *See C. M. Joiner Leasing,* 320 U.S. at 351 ("We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included in any of these definitions, as a matter of law, if on their face they answer to the name or description").

In accordance with this legislative intent, this Court has repeatedly declared that the definition of "investment contract" must be construed broadly to effectuate the remedial purposes of the federal securities laws and to protect investors. *See Howey,* 328 U.S. at 299, 301; *see also Tcherepnin v. Knight,* 389 U.S 332, 336 (1967). The appellate court ignored these principles. It seized upon a restrictive interpretation of *Forman* and adopted a "limited meaning" of the word "profits." *See* 300 F.3d at 1284. The resulting dismissal of the SEC's enforcement action against an enterprise that defrauded thousands of investors was at odds with the remedial purposes of the federal securities laws.

2. Federal Court Decisions

The appellate court's decision also conflicts with this Court's original formulation of the investment contract definition, as well as subsequent judicial interpretations of the term. In *Howey,* the Court expressly adopted state court decisions as a guide for defining the term "investment contract," because state courts had developed a definition for that phrase under blue sky laws enacted prior to the federal securities laws. *See Howey,* 328 U.S. at 298. Borrowing directly from state case law, the Court formulated the

definition in terms of "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." *Id.* at 298-99. As the foundation for this definition, the Court cited seven state cases, three of which involved investment contracts offering fixed returns. *Id* at n.4. *See People v. White,* 12 P.2d 1078, 1079, 1081 (Cal. Dist. Ct. App. 1932) (investment contracts found where promoter offered a $7500 return on $5000 invested in enterprise trading trust deeds, stocks of bankrupt companies, and foreclosure instruments); *Stevens v. Liberty Packing Corp.,* 161 A. 193, 194, 195 (N.J. Ch. 1932) (investment contract found where promoter offered fixed amount per offspring in breeding scheme involving sale and leaseback of rabbits); *Prohaska v. Hemmer-Miller Devel. Co.,* 256 Ill. App. 331 (Ill. Ct. App. 1930) (investment contract found where investor stood to receive up to two-thirds of the price of a land parcel, but not more). Since its early days, then, the concept of an investment contract under federal law has included offerings with fixed returns.[10]

Elsewhere in the *Howey* opinion, the Court used a variety of terms interchangeably to describe an investor's expectations under an investment contract, including "income," "profit," and "financial returns." *See Howey,* 328 U.S. at 298, 300. All of these words encompass fixed as well as variable returns. Removing any doubt on the issue, the Court in *Howey* declared: "It is immaterial whether the enterprise is speculative or non-speculative . . . . The statutory policy of

[10] In *Howey,* the Court observed that the term investment contract had been broadly construed by the states "so as to afford the investing public a full measure of protection" 328 U.S. at 298. The federal securities laws were intended to be even more broadly applied, in light of the "ingenuity and fertility of resources of those dealers in securities who deliberately attempted to avoid" application of blue sky laws. *See SEC v. Crude Oil Corp.*, 93 F.2d 844 (7th Cir. 1937).

affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *See Howey,* 328 U.S. at 301.

The *Forman* case is not to the contrary. Once again, the Court's choice of words belies the appellate court's narrow interpretation. In *Forman,* the Court repeatedly used terminology that is consistent with fixed as well as variable returns: "income," "profits," and "financial return." *See United Hous. Found., Inc. v. Forman,* 421 U.S. at 851-53. The Court's reference to "participation in earnings" was not an attempt to graft technical distinctions—such as fixed versus variable rates—onto investment contract analysis, but to differentiate the expectations of an investor from those of someone seeking to use or consume a commodity. *See Forman,* 421 U.S. at 852-53. The holding in *Forman* rested squarely on this point, not on notions of fixed or variable returns: "What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use." *Id.* at 853. On this basis, the Court held that stock in a non-profit housing cooperative was not an investment contract. In contrast with the *Forman* case, investors in the ETS program were motivated by the lure of profits, not by a desire to acquire telephones. The ETS offerings were investment contracts.[11]

[11] Even if "participation in earnings" were the litmus test for investment contracts, the appellate court's decision would still be incorrect because receiving fixed returns does not preclude one from participating in earnings. To the extent ETS investors actually received fixed monthly yields from pay phone operations, they would have been *participating* in earnings because their returns would have been *paid* from earnings. The appellate court conceded as much: "Of course, the funds generated by the pay phones helped ETS meet its obligations." 300 F.3d at 1285.

The appellate court's interpretation of profits is inconsistent with decisions issued in at least four other federal circuits. In *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001), the promoters of an investment trust argued that shares in their program were not investment contracts because they featured a fixed rate of return rather than a rate dependent upon the success of the investments. The Third Circuit flatly rejected this defense, holding that "the definition of a security does not turn on whether the investor receives a variable or fixed rate of return." *Id.* at 189. In *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001), the First Circuit had no difficulty finding an "expectation of profits" where a promoter of "virtual companies" on the internet "flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% . . . ." *Id.* at 54.

The Seventh and Ninth Circuit Courts of Appeals also have found offerings to be investment contracts notwithstanding fixed returns. In *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978), the court held that fixed interest on student loans guaranteed by the federal government was nevertheless profit to be derived from the efforts of others. The court focused on the investors' passive role and continuing dependence upon the promoter's sound management and solvency to avoid certain risks of loss. *Id.* at 563. Those risks were deemed "sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed." *Id.* As early as 1939, the Seventh Circuit held that an investment in a supposedly novel agricultural operation, promising 30% annual returns, was a security under the early investment contract standard. *See SEC v. Universal Service Ass'n*, 106 F.2d 232, 237-38 (7th Cir. 1939). The court adhered to this result, even though the defendant was

actually insolvent and the promised returns of 30% would have been "paid not from any profit, but from new contributions." *Id.* at 239.[12]

3. State Court Decisions

The appellate court's decision conflicts with the decisions of several state supreme courts.[13] In *State v. Gertsch*, 49 P.3d 392 (Idaho 2002), the defendant sold investments in a vaguely described business enterprise that was, in reality, a classic Ponzi scheme. *Id.* at 394, 397-98. The investors

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[12] Another line of Supreme Court and circuit court cases provides an independent basis for reversing the appellate court's decision at issue here. The Supreme Court has held that the nature of an investment offering may be determined by the representations that promoters have used to sell it to the public. *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943) (oil leases combined with test drilling services). Until the appellate court issued its decision in this case, the Eleventh Circuit followed this approach. *See SEC v. Unique Financial Concepts*, 196 F.3d 1195 (11th Cir. 1999) (sham investment in foreign currency options evaluated under *Howey* in terms of the promoter's representations). Respondent Edwards quite clearly used the lure of "profits" to offer and sell his pay phone investments, and under this line of cases, he cannot now disavow the status of those offerings as investment contracts. *See* Ex. 15, at 5, 7, 8, 9; Ex. 17, at 4, 5, 8, 9, 10, 11; Ex. 22, at 1,5.

[13] As a threshold matter, state court decisions are relevant in this case for two reasons. First, as discussed in the text above, the term "investment contract" originated in state securities laws enacted during the early 1900's, and was interpreted extensively by state courts before Congress enacted the federal securities laws. *See Howey*, 328 U.S. at 298. For this reason, the Court in *Howey* expressly adopted state judicial interpretations of the term "investment contract" as a guide to its meaning under federal law. *Id.* Second, virtually every state securities law in the country includes a definition of the term "security" that parallels the federal definition by expressly including "investment contracts." Therefore, more recent state court decisions, as well as the early state cases that helped establish the investment contract definition, continue to serve as a useful guide to the meaning of the term.

expected to receive a very high, fixed return of 25% quarterly. *Id.* at 394. The defendant asserted that the transactions resembled bank loans more than capital investments and that the unconditional promise to pay coupled with the fixed return precluded a finding that the investors sought profits. *Id.* at 398. The Idaho Supreme Court, citing principally to the Ninth Circuit's decision in *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978), rejected this defense and held that the transactions were investment contracts. *State v. Gertsch,* 49 P.3d at 399. The court observed that the investors did not perceive the transactions as loans, that they were in fact dependent upon the efforts of the defendant to cultivate new investors, and that despite the promise of a fixed return, they faced substantial risk. *Id.* at 398-99. In light of these facts, the court upheld the jury's finding that "investors sought the return of profits to be made from the entrepreneurial efforts of others." *Id.* The court furthermore noted that the high rate of return could be viewed as a "cap" on the profits expected from the venture." *Id.* at 399. Similarly, while the fixed rate of return promised by ETS may have represented an upper limit on investors' profits, it in no way altered the fundamental character of those profits as derived from the efforts of others.

In *Payable Accounting Corp. v. McKinley,* 667 P.2d 15 (Utah 1983), investors contributed cash and other assets to fund a payroll management business, for which the company promised to pay fixed monthly interest. *Id.* at 16-17. The Supreme Court of Utah held that the arrangement was an investment contract under *Howey* notwithstanding the fixed rate of return:

> The crucial factor is not whether the rate of return is fixed, but whether the "investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise". . . . That the investors receive a fixed rate of return does not make this scheme any less an investment contract. The money to pay off the investors is still generated by PAC, and the risk of loss still depends on PAC's managerial skills.

Id. at 19, 21 (quoting *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 829 n.5 (N.D. Tex. 1981), *aff'd,* 704 F.2d 199 (5th Cir. 1983), *cert. denied,* 464 U.S. 852 (1983)).

In *Gaudina v. Haberman,* 644 P.2d 159 (Wyo. 1982), the defendant offered interests in a trust account that was established to acquire supposedly "top quality" investments such as loans secured by real estate mortgages. The promised rate of return was 14%. The Supreme Court of Wyoming held that this investment offering fit the *Howey* definition of investment contract "like a glove." *Id.* at 164, 166. In *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979), the plaintiff invested in a retail appliance leasing business in return for 12% fixed interest payable monthly. *Id.* at 1208. The Supreme Court of Washington held that the arrangement was an investment contract under *Howey,* because even though the investor's return may have been constant, she was still subject to the risk of loss of her entire investment if the management failed to sustain the company's profitability. *Id.* at 1210; *cf. King v. Pope*, 91 S.W.3d 314 (Tenn. 2002) (holding ETS contracts are securities based upon the *Hawaii Markets* analysis).

More recently, trial courts in Colorado and Iowa have held that pay phone sale and leaseback investments, including the ETS contract and a similar version offered by Phoenix telecom, were investment contracts. *See Joseph v. Geier,* No. 01 CV 1151, at 2 (Colo. D. Ct., Denver County, Jan. 30, 2003) (Order on Motions for Summary Judgment) (a fixed rate of return does not take an investment contract out of the definition of a security; to hold otherwise would gut the effectiveness of the Colorado Securities Act in protecting investors against a broad range of investment schemes); *Iowa*

ex rel. Miller v. Pace, Equity No. LA26445, at 17 (Iowa D. Ct., Warren County Sept. 4, 2002), *appeal docketed,* No. 02-1726 (Iowa Oct. 28, 2002) (irrelevant that inducements leading an investor to risk his initial investment are founded on promises of fixed returns rather than a share of profits).[14]

4. Regulatory Interpretation

The appellate court's decision also conflicts with interpretations of the securities laws that federal and state securities regulators have applied for years. Under the principle of deference to administrative interpretation, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

The SEC's position that investment contracts include fixed and guaranteed returns is reflected in the enforcement actions described above, *supra* at Part I.A., and in the authorities discussed in the SEC's Petition for a Writ of Certiorari, at 23-26. State securities regulators also have brought innumerable enforcement actions against ETS, their sales agents, and other companies offering similar sale and leaseback programs. *See, e.g.*, actions discussed *supra* at Part I.A. Thus far, state administrative law judges and commissions have rejected arguments that fixed or guaranteed returns place an investment beyond the reach of *Howey*. For example, in *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL

[14] Since 1939, a minority line of cases has emerged holding that payment of a fixed fee such as interest does not meet the profits test. *See* 12 Joseph C. Long, Blue Sky Law § 2.58 (2002) and cases cited therein. However, these decisions have been viewed as "defective" for two reasons. First, the distinction between dividends and interest is often arbitrary and subject to the control of the promoter. Second, the real focus of the *Howey* profits test is on the motivation of the investor, not the specific nature of the profits or losses of the enterprise. *Id.*

31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order), the Florida Department of Banking and Finance rejected the Eleventh Circuit's narrow interpretation of "profits," observing that the Department had characterized the ETS pay phone contracts and similar offerings as securities for ten years. *See id.* at *3; *see also Stigall v. Sec'y of State,* No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002) (Final Decision) (definition of profits is broader than Eleventh Circuit test and includes interest); *Garvin v. Sec'y of State,* No. OSAH-SEC STATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration) ("An offeror may not avoid registration of a security in Georgia merely by establishing a fixed rate of return on the investment"). *But cf. In re Rahaim,* No. E-2000-22, at 5 (Mass. Sec. Div. July 11, 2000) (Memorandum and Order).[15] These interpretations of the securities laws by the regulatory agencies tasked with administering them support reversal of the appellate court's decision.

B. The Appellate Court's Interpretation of the "Efforts of Others" Test Is Plainly Misguided

As an alternative basis for its decision, the appellate court ruled that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *See* 300 F.3d at 1285. This aspect of the appellate court's ruling is illogical and—like the court's principal basis for decision discussed above—irreconcilable with statutory analysis, case law, and regulatory interpretation.

The court's ruling is conceptually flawed because the efforts giving rise to the profits of an enterprise bear no logical relationship to whether or not those profits are guaranteed to an investor. An analysis of the court's decision

[15] The *Rahaim* decision did not rest on the "profits" or "efforts of others" elements of *Howey*, but rather on the ALJ's view that a common enterprise was absent. *See In re Rahaim,* No. E-2000-22, at 4, 9.

reflects this logical defect at every turn. With respect to the statutory language, nothing in the phrase "investment contract" suggests the exclusion of contractually guaranteed returns. Quite the opposite: use of the word "contract" indicates that this category of investment was intended to encompass contractual promises of many varieties, including guarantees. The appellate court offers no authority to support its contrary reading of the statute.

With respect to the case law, courts generally do not focus on guarantees in connection with the "efforts of others" analysis. Decisions from the federal circuit courts have established that the appropriate inquiry under the third element of *Howey* is not whether returns are contractually guaranteed, but "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See, e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

Prior to this case, the Eleventh Circuit followed this approach. In *Albanese v. Florida Nat'l Bank of Orlando,* 823 F.2d 408 (11th Cir. 1987), involving an ice machine sale and leaseback scheme, the court found that the promoters retained managerial control over the ice machines and on this basis held that the "efforts of others" test was satisfied. *Id.* at 410-412. With respect to the third prong of *Howey,* the court stated that "Under the precedent of this circuit, the crucial inquiry is the amount of control that the investors retain under their written agreements." *Id.* at 410.

Courts specifically addressing the guarantee issue have rejected the notion that a guarantee negates the "efforts of others" element. In *SEC v. G. Weeks Securities, Inc.*, 678 F.2d 649 (6th Cir. 1982), the Sixth Circuit actually held that a guarantee provision was what made the offering an investment contract. The appellant in *Weeks* offered "standby pair-offs" on GNMA certificates, which essentially involved

buying and selling combinations of GNMA forward contracts. *Id.* at 650. Investors were guaranteed a positive rate of return. *Id.* at 652-53. The court found that the guarantee distinguished the offerings from conventional forward contracts and brought them within the ambit of *Howey*:

> Appellant's scheme, the standby with pair-off, offered an inducement available under neither form of the traditional forward contract, a guaranteed return . . . . G. Weeks Securities could accept the risk of adverse price fluctuations and guarantee a positive return only if they successfully invested the commitment fees deposited by investors. Thus, the standby pair-off would appear to fit precisely the Supreme Court's definition of a security.

Id. at 652-53. Under this reasoning, the ETS guarantee heightened rather than diminished the importance of the promoters' efforts. The investors' entitlement to a fixed and positive return presumably required the company to work ever more strenuously either to manage the pay phones successfully or recruit additional investors in the tradition of a Ponzi scheme.

The Ninth Circuit, in *United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978), has expressly rejected the argument that a guaranteed return vitiates the "efforts of others element." There the defendants sold fixed rate, federally guaranteed packages of student loans, along with service contracts. *Id.* at 560, 563-64. Against charges of securities fraud, the defendants argued that their offerings were not securities because returns were in the form of guaranteed fixed interest, which did not depend upon the promoters' efforts. *Id.* at 563. The Ninth Circuit rejected this argument, observing that the investors had a passive role and were in fact dependent upon the "sound management and continued solvency" of the promoter to maintain the guarantee in place

and absorb potential refund liability under the notes. *Id.* Similarly in this case, ETS investors were passive, and they relied upon ETS's continuing efforts to manage the pay phones—or entice additional investors—to pay the promised returns.

State administrative rulings have reached the same result. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *3 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) (ETS guarantee served only to lull the investor into a feeling of security); *Stigall v. Sec'y of State,* No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002) (Final Decision) (contractual guarantee of payment that might be satisfied from capital deemed irrelevant).

C. The Appellate Court's Rulings Have No Rationale Under the Securities Laws

Neither of the appellate court's rulings can be reconciled with the underlying rationale of the securities laws or the cases interpreting them. There is no reason to distinguish investment contracts with fixed or guaranteed returns from those lacking these features. The securities laws were intended to provide investors with certain safeguards because they place their funds at risk. The economic reality is that neither fixed nor guaranteed returns—even from a legitimate business enterprise—can eliminate such risk. Promises may be broken and companies may go bankrupt, as ETS did in this case, from either mismanagement or outright fraud. Very often, in fact, promises of fixed returns and assurances of guaranteed profits are merely sales pitches, not genuine risk-reducing features of an investment. Accordingly, investors require the protections of the securities laws whether or not their returns are fixed or nominally "guaranteed." *Cf. Tcherepnin v. Knight,* 389 U.S. 332, 336 (1967) (in the analysis of investment contracts, "form is to be disregarded over substance" and the emphasis should be on "economic reality"). In terms of the underlying rationale of investor

protection, there is no principled basis for distinguishing investment contracts offering fixed or guaranteed returns from those that do not.

Nor do the facts of this case suggest any basis for treating pay phone promoters differently than other issuers under an investment contract analysis. Nothing about the nature of the ETS contracts and their inherent risks, the investors to whom they were marketed, or the promoters themselves can justify the distinctions drawn by the appellate court. In fact, pay phone sale and leaseback programs represent precisely the type of investment that the securities laws were intended to reach. These products must be subject to continued regulation at the federal and state level for the protection of investors.

CONCLUSION

For the reasons set forth above, the Eleventh Circuit's decision should be reversed.

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IN THE SUPREME COURT OF THE UNITED STATES

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Writ of Certiorari to The United States Court of Appeals for the Eleventh Circuit

BRIEF *AMICUS CURIAE* OF AARP IN SUPPORT OF PETITIONER

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No. 02-1196

IN THE
SUPREME COURT OF THE UNITED STATES

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Writ of Certiorari to the
United States Court of Appeals
For the Eleventh Circuit

BRIEF *AMICUS CURIAE* OF AARP IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*[1/]

AARP is a nonpartisan, nonprofit organization with 35 million members, dedicated to addressing the needs and interests of Americans age 50 and older. As the largest membership organization representing the interests of older Americans, AARP is greatly concerned about the rampant deception, fraud, and unfair practices perpetrated upon consumers in a broad range of transactions since older Americans are disproportionately victimized by such practices. For example, older Americans are frequent targets of investment fraud because they often have significant assets and

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[1/] Letters of consent from both parties have been filed with the Clerk. No counsel for a party authored this brief in whole or in part, and no person or entity other than amicus curiae or its counsel made a monetary contribution to the preparation and submission of this brief.

are looking for investment opportunities that will supplement their Social Security and pension benefits received during retirement.

AARP thus supports laws and public policies that will protect older persons and preserve the legal means for redress when they are harmed in the marketplace. In the investment area, AARP has commented on legislative and regulatory proposals that address fraudulent and deceptive conduct, filed briefs as *amicus curiae* in cases involving interpretation of the federal securities' laws, e.g., *SEC v. Zandford,* 535 U.S. 813 (2002), and opposed efforts to limit federal statutory remedies that allow defrauded investors to obtain financial redress. In addition, AARP has undertaken efforts to educate investors about how to choose financial professionals who will act in their best financial interest.

AARP believes that the interpretation of the securities' laws adopted by the decision below improperly undermines the ability of those victimized by fraud to obtain recovery for their injuries, contrary to both the language and the policies of federal securities' laws. AARP, therefore, is concerned that if the Eleventh Circuit's decision is affirmed, enforcement of and protections currently afforded investors under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* and the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* will be diminished.

SUMMARY OF ARGUMENT

The Eleventh Circuit erred when holding that Respondent's payphone leaseback investment scheme was not an "investment contract" covered under the federal securities' laws. The court's ruling that "investment contracts" do not exist where the promised return on an investment is fixed rather than variable unduly restricts the definition of "investment contract." The federal securities' laws are construed flexibly in order to effectuate the laws' remedial purposes. *SEC v. Zandford*, 535 U.S. 813, 819 (2002). Congress enacted the securities' laws "to regulate investments, in whatever form they are made and by whatever name they are

called."*Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990). In order to achieve its goal to protect investors, Congress defined 'security' broadly to "encompass virtually any instrument that might be sold as an investment." *Id.* By excluding investments with fixed or contractually promised returns from the definition of "investment contract," the court of appeals failed to apply a flexible interpretation, thereby allowing perpetrators of fraud an avenue in which they can operate while evading the law. Undoubtedly, fraud perpetrators, in order to evade the law, will quickly learn to adjust their tactics by promising a fixed rate of return on a purported investment. If this sort of loop hole in the federal securities' laws is allowed to become the law of the land and fraudsters begin to evade the laws with impunity, there will be dire consequences for the older and less sophisticated investor who are the most frequent targets of fraudulent investment schemes.

In recent years, Americans have entered our nation's securities markets in record numbers, many for the first time. This is due, in large part, to the recognition that individuals have to plan and provide for their retirement security with less reliance on Social Security and traditional employer-sponsored defined benefit pension plans. Also, due to the volatility of U.S. markets, older Americans dependent on predictable interest income are looking for safe havens and therefore are susceptible to scams that offer investments with purported low risks and high returns.

As the number of investors has increased, so has the incidence of investment fraud and unfair practices. As in the instant case, investment fraud is not limited to the sale of traditional securities such as stocks and bonds. Unfortunately, many older first time investors lack the basic skills and necessary information to manage and oversee their investments, making them even more vulnerable to fraudsters. As a result, unsophisticated investors often misplace their trust in individuals who are not acting in the investor's best interest or are even engaging in an outright fraudulent scheme. After unwittingly placing their retirement nest egg in jeopardy, older investors too often tragically lose their life savings, at a time in their lives when it is needed the most. Our vulnerable

investors, therefore, need greater protection from fraudsters, not less.

Unless the Court reverses the Eleventh Circuit and upholds the standard intended by Congress and advanced by Petitioner, essential legal protections intended to benefit investors will be eroded, and America's individual investors and their financial futures will remain at the mercy of unscrupulous practitioners.

ARGUMENT

I. FEDERAL SECURITIES' LAWS SHOULD BE BROADLY CONSTRUED IN ORDER TO EFFECTUATE THEIR REMEDIAL PURPOSES.

The Eleventh Circuit erred when holding that Respondent's payphone leaseback investment scheme was not an "investment contract" covered under the federal securities' laws. The court's ruling that "investment contracts" do not exist where the promised return on an investment is fixed rather than variable unduly restricts the definition of "investment contract." The court of appeals' decision, thereby, undermines Congress' goal to enact flexible securities' laws in order to protect vulnerable investors from varied investment scams and deceitful advisors and brokers.

The federal securities' laws are construed flexibly in order to effectuate the laws' remedial purposes. *SEC v. Zandford*, 535 U.S. 813, 819 (2002). Congress enacted the securities' laws "to regulate investments, in whatever form they are made and by whatever name they are called." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990). In order to achieve its goal to protect investors, Congress defined "'security' broadly to encompass virtually any instrument that might be sold as an investment." *Id.* Thus, Congress included in the definition of "security" in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10), the term "investment contracts," in

addition to conventional securities, such as stocks and bonds.[2/] An investment contract is "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946). As such, investment contracts include "[n]ovel, uncommon, or irregular" investment products. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). *See also SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 211(1967) (holding that annuities that promised financial "'growth' through sound investment management" were investment contracts); *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001) (holding that the promise of a fixed return for transferring money to a trust was an investment contract); *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978) (holding that sale of a student promissory note with a fixed return was an investment contract).[3/]

II. COURTS MUST LOOK AT THE SUBSTANCE NOT THE FORM OF A TRANSACTION WHEN DETERMINING WHETHER FRAUDULENT CONDUCT IS COVERED UNDER FEDERAL SECURITIES' LAWS.

To effectuate Congressional intent, courts must look at the substance not the form of a transaction when determining whether fraudulent conduct is covered under the securities' laws. *Howey*, 328 U.S. at 298, 301 (holding that the statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae). To allow the Eleventh Circuit's decision to stand, therefore, would be in contravention of Congress' intent that the definition of

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[2/] An "investment contract" is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946).

[3/] The court of appeals' decision also conflicts with the Securities Exchange Commission's (SEC's) formal adjudicatory opinions. *See*, SEC Pet. at 23-24.

securities must be sufficiently flexible so that the laws protect investors from the countless and constantly changing schemes devised by fraud perpetrators. *Howey*, 328 U.S. at 299.

By excluding investments with fixed or contractually promised returns from the definition of "investment contract," the court of appeals' decision will allow perpetrators of fraud an avenue in which they can operate while evading Securities' laws. Fraud perpetrators will quickly learn to evade securities' laws by promising a fixed rate of return on a purported investment. If this sort of loop hole in the federal securities' laws is allowed to become the law of the land and fraudsters begin to evade these laws with impunity, there will be dire consequences for the older and less sophisticated investors who are the most frequent targets of fraudulent investment schemes.

A. When Looking At the Substance of ETS' Payphone Leaseback Investment Scheme, It Is Evident That It Is an "Investment Contract" under the Federal Securities' Laws.

When looking at the substance, as opposed to the form, of the transaction in dispute here, Respondent's nationwide payphone leaseback investment scheme falls within the definition of an "investment contract" under the federal securities' laws. Section 2(a)(1) of the Securities Act, 15 U.S.C. § 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(10). The SEC charged that Respondent, Charles E. Edwards, through its company ETS Payphones (ETS), fraudulently sold to mostly elderly, inexperienced investors in thirty-eight states coin-operated telephones that carried lease back agreements to ETS. ETS, acting through distributors, who were primarily licensed insurance agents, and other advertisement avenues such as the Internet and mailed brochures, sold the leased back phones by promising profits as high as a fixed 14.1 percent annual rate of return.

Unfortunately for investors, the Respondent's promises of profits were false and most of Respondent's investors lost

their entire investment. The district court found that Respondent's "actions were egregious in operating an investment scheme at a significant loss while only [Respondent] profited." *SEC v. ETS Payphones Inc., et al.*, 123 F. Supp. 2d 1349, 1355 (N.D. GA 2000). The district court found that ETS continued to advertise that the leaseback payphones were a very profitable investment while at the same time ETS was losing millions of dollars. For example, from November 1998 to March 1999, ETS had an operating loss of $32 million and therefore the company had to attract an ever expanding number of investors to meet its obligations to existing investors. Moreover, notwithstanding the company's enormous undisclosed losses, ETS paid Respondent Edwards $2.24 million in compensation and made $11.6 million in interest free loans to companies controlled by Edwards. *Id.* at 1352.

III. OLDER INVESTORS ARE FREQUENT TARGETS OF FRAUD AND THUS NEED ANTI-FRAUD PROTECTIONS MAINTAINED UNDER THE SECURITIES' LAWS.

Older Americans are disproportionately likely to be victimized by fraud as compared to younger people. *See* Friedman, *Confidence Swindles of Older Consumers*, 26 J.Consumer Aff. 20 (1992); Richard A. Starnes, Note, *Consumer Fraud and the Elderly: The Need for A Uniform System of Enforcement and Increased Civil and Criminal Penalties*, 4 Elder L.J. 201(1996) (citing studies). Frauds perpetrated against older people cause especially devastating consequences since the "likelihood that an elder person's income is fixed may make it extremely difficult to recover from a financial loss." Carolyn L. Dessin, *Financial Abuse of the Elderly*, 36 Idaho L. Rev. 203, 205 (2000).

Older Americans are the primary targets of investment con artists. Additionally, stockbrokers and financial planners who engage in abusive practices often seek out the elderly. North American Securities Administrators Association (NASAA), Investor Tips, How Older Americans Can Avoid Investment Fraud and Abuse (June 22, 2003), *at*

http://www.nasaa.org/nasaa/scripts/tx_display.asp?rcid=29. *See also* United States Postal Inspection Service, Investment Fraud Schemes, *at* http://www.usps.com/postalinspectors/invest.htm (last visited June 24, 2003).

A. Securities Fraud Is a Pervasive Problem.

State regulators estimate that securities fraud costs Americans billions of dollars each year. Press Release, NASAA, Securities Regulators Unveil Fraud Awareness Quiz (April 30, 2003), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=199. Indeed, securities fraud and unfair practices continue to present a pervasive problem for American investors. *See, e.g.*, Press Release, NASAA, Securities and Exchange Commission (SEC), N.Y. Attorney Gen., Nat'l Assoc. of Securities Dealers, and N.Y. Stock Exch., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (April 28, 2003), *available at* http://www.nasaa.org/nasaa/Files/File_Uploads/Press%20release%20for%20posting.37737-80425.pdf (announcing global settlement of enforcement actions against ten of the nation's top investment firms, which were charged with conflicts of interest, requiring the firms to pay penalties of $487.5 million, disgorgement of $387.5 million, payments of $432.5 million to fund independent research, and payments of $80 million to fund investor education); SEC, Report of the Securities and Exchange Commission: Section 703 of Sarbanes-Oxley Act of 2002, Study and Report on Violations by Securities Professionals (Jan. 24, 2003), *available at* http://www.sec.gov/news/studies/sox703report.pdf(finding that securities professionals who violated securities' laws from 1998 - 2001 most frequently violated the anti-fraud provisions: Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78(j) and Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(q)).

Investment fraud is not limited to the sale of traditional securities such as stocks and bonds. "Our volatile markets have investors, particularly older Americans dependent on predictable interest income, looking for safe havens. So scammers are pitching their investments as low risk and high

return," according to Deborah Bortner, president of the North American Securities Administrators Association (NASAA) and Washington State's director of securities. Press Release, NASAA, Top 10 Investment Scams (Apr. 23, 2003), *available at* http://www.nasaa.org/nasaa /scripts/prel_displayasp?r.cid =153.[4/] For example, major brokerage houses peddled high risk limited partnerships, falsely touting their suitability for conservative and older investors. *Coming to Terms, CSFB Agrees to Pay $100 Million to Settle Twin IPO Investigations,* Wall St. J., Dec. 11, 2001, at A1 (SEC announcing Credit Suisse First Boston will pay $100 million to resolve federal investigation into alleged abuses in distribution of its IPOs). *See also* Press Release, NASAA, Terror Fears Exploited (Mar. 18, 2003), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=195 (warning that in the wake of the September 11, 2001 attacks, con artists were promoting investments in bogus companies touting anthrax detectors and "revolutionary" security-enhancing technologies); Press Release, NASAA, Beware of Oil and Gas Schemes (Mar. 6, 2003), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=193 (warning that con-artists seeking to exploit fears over Mideast conflicts were promoting fraudulent oil investments); *In re Prudential Sec. Inc. Ltd. P'ship Litig.*, 163 F.R.D. 200 (S.D.N.Y. 1995) (describing $110 million settlement with an investor class growing out of Prudential's fraudulent marketing of 700 limited partnership units); *In re PaineWebber Ltd. P'ship Litig.*, 171 F.R.D. 104, 106 (S.D.N.Y. 1997) (approving $200 million settlement in action growing out of limited partnership sales).

[4/] Included among the "Top Ten Investment Scams" listed by State Securities Regulators were (1) unlicenced individuals, such as life insurance agents, selling securities; (2) affinity group fraud where scammers use their victim's religious or ethnic identity to gain their trust; (3) payphone and ATM type sales; (4) promissory notes issued by little-known or sometimes non-existent companies that promise high returns and little or no risk; (5) ponzi/pyramid schemes where scammers promise high returns to investors, but the only people who consistently make money are the promoters; (6) callable CDs sold to elderly investors, which do not mature for 10- to 20 -years, unless the bank, not the investor, "calls," or redeems, them; (7) viatical settlements purporting to sell interests in the death benefits of terminally ill patients; and (8) prime bank schemes where scammers promise investors triple-digit returns through access to the investment portfolios of the world's elite banks. *Id.*

B. Individuals Are Investing in the Securities Markets in Unprecedented Numbers, Often For the First Time.

Americans have departed, in unprecedented numbers, from placing primary reliance on federally-insured products, such as savings accounts and certificates of deposit, for their retirement needs. "The past two decades have brought enormous change to Wall Street and all our financial markets. We're now a nation of investors, 84 million strong; half of all U.S. households own stocks or mutual funds. Americans are relying on securities products and our securities markets to create the wealth they will need for retirement...." Press Release, NASAA, Putting Investors First: A Legislative Agenda for 2003 (Dec.23,2002), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=190.

Americans are investing in greater numbers in large part because individuals have to plan and provide for their retirement security with less reliance on Social Security and traditional employer-sponsored defined benefit pension plans. Social Security is expected to provide proportionately less of a retiree's needed retirement income. AARP, PPI, Beyond 50: A Report to the Nation on Economic Security (Apr. 2003), *available at* http://research.aarp.org/general/beyond_50.htm. For example, in a recent study, 401(k) accumulations are projected to generate income to replace at least 51 percent of pre-retirement income for half of retirees in the lowest income quartile and at least 69 percent for half of those in the highest income quartile. Sarah Holden & Jack VanDerhei1, *Can 401(k) Accumulations Generate Significant Income for Future Retirees?*, Investment Company Institute Perspective, Vol. 8 / No. 3, (Nov. 2002), *available at* http://www.ici.org/ici_frameset.html.

Accordingly, assets[5/] in the U.S. retirement market rose to $10.9 trillion at year-end 2001 according to the Investment

[5/] Retirement assets include individual retirement accounts, annuities, and employer-sponsored defined benefit and defined contribution pension plans.

Company Institute ("ICI").[6/] ICI, Mutual Funds and the U.S. Retirement Market in 2001, Fundamentals, Research in Brief, Vol. 11 / No. 2, (June 2002), *available at* http://www.ici.org/ici_frameset.html. *See also* ICI, U.S. Household Ownership of Mutual Funds in 2002, ICI Research in Brief, Vol. 11/ No. 5 (October 2002), *available at* http://www.ici.org/ici_frameset.html (reporting that an estimated 54.2 million U.S. households owned mutual funds in May 2002,[7/] representing 49.6 percent of all U.S. household compared with 5.7% in 1980).

The potential for fraud and other abuses significantly increases as large numbers of first-time investors enter the securities markets and, due to their relative lack of sophistication and high financial illiteracy, rely on a range of planners and sales agents for investment advice.

C. Individual Investors Have Extremely Low Levels of "Financial Literacy" Making Them Susceptible to Fraud

Several studies conducted by government agencies, financial services corporations, and non-profit organizations have found that individual investors lack even the most rudimentary knowledge needed to make informed investment decisions. Investors do not know the basics of how investments work, and they do not even know what they are doing with their own money. The Securities Investor Protection Corporation and the National Association of Investors Corporation recently reported that 85% of American

[6/] The Investment Company Institute is the national association of the American investment company industry. Founded in 1940, its membership includes 8,710 mutual funds, 481 closed-end funds, and 7 sponsors of unit investment trusts.

[7/] This number reflects a decrease from a revised 56.3 million in May 2001 due to a market downturn. *Id.* However, the combined assets of the nation's mutual funds increased by $220 billion, or 3.5 percent, to $6.485 trillion from March to April 2003, according to the Investment Company Institute's official survey of the mutual fund industry. ICI, Trends In Mutual Fund Investing (April 2003), *available at* http://www.ici.org/ici_frameset.html.

investors do not know enough to pass a "survival" quiz designed to assess their knowledge of what to do in times of market downturns and other financial difficulties. For example, almost two in three investors do not know the first step to take when they suspect they are dealing with a problem broker, and fewer than one in five knows there is no insurance for stock market losses. Press Release, Securities Investor Protection Corp. & Nat'l Assoc. of Investors Corp., Survey: More Than 4 Out of 5 U.S. Investors Fail Quiz of Basic "Survival" Knowledge (Aug. 1, 2001), *available at* http://216.181.142.217/sipc/release0.html. *See also* Ruth Simon, *We Put Investors to the Test -- and, Boy, Did They Ever Flunk*, Money, Mar. 1998, at 37 (reporting on results of MONEY/Vanguard Mutual Fund Literacy Test where mutual fund investors scored an average of just 51 out of 100); Towers Perrin, Preparing for Retirement: A Survey of 1,000 Working Americans 9 (Feb. 1995) (reporting that one-third of 401(k) or other retirement savings plan investors think there is no risk associated with bonds, and 14% think there is no risk associated with "mutual fund" or "balanced" fund investments) (reports on file with AARP).

An AARP survey revealed that experienced investors with full-service brokerage accounts do not understand much of the information on typical account statements, including basic terms such as "equity," or fundamental transactions, such as the number of shares reinvested in a particular fund to determine investor awareness of broker compensation practices. AARP, Investor Understanding of Broker Account Statements: Findings From a Survey 5-6 (Oct. 2000), *available at* http://research.aarp.org/consume/broker.pdf. Another AARP survey of people 50 and older confirmed that investors are unaware of the conflicts of interest that may arise because of practices, such as sales contests and higher commissions for the sale of proprietary products. AARP, Investor Awareness of Broker Compensation Practices: Findings From an AARP Survey 3-4 (Apr. 1998) (on file with AARP).

Alarmingly, these findings show that individual investors are not adequately equipped to oversee their

investments. "America faces a financial literacy crisis. At a time when more Americans than ever before are investing in our securities markets through the purchase and sale of stocks, bonds, and mutual funds, numerous studies show they lack the financial basics." SEC, Office of Investor Education and Assistance, The Facts on Saving and Investing 2 (Apr. 1999) (on file with AARP). Lacking basic knowledge of how the securities markets operate, and being unaware of the fundamental features of their own investments, individual investors rely in large measure on third parties for advice on the purchase and sale of securities. More than 80% of new mutual fund purchases were made through intermediaries such as brokers, banks, financial planners, insurance agents, and employers,[8/] and 37% of shareholders purchase funds primarily through full-service brokers, insurance agents, financial planners, or bank representatives. ICI, Frequently Asked Questions About Mutual Fund Shareholders (Oct. 2002), *at* http://www.ici.org/ici_frameset.html. In spite of this, almost four-fifths (79%) of investors feel it is difficult to know how to choose a good professional investment advisor. SEC, The Facts on Saving and Investing, *supra*, at 24.

Individual investors' lack of knowledge about the securities markets, their own investments, and how to choose trustworthy financial professionals place these investors at great risk of being defrauded by unscrupulous practitioners.

[8/] Nearly half (48%) of mutual fund shareholders identified an employer-sponsored retirement plan as their primary method for purchasing mutual funds, and 57% bought their first fund through these plans. ICI, Frequently Asked Questions About Mutual Fund Shareholders (Oct. 2002), *at* http://www.ici.org/ici_frameset.html.

CONCLUSION

For the foregoing reasons, AARP requests that the Court reverse the Eleventh Circuit's ruling in this case.

June 26, 2003

Respectfully submitted,

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(16)

Supreme Court Case No. 02-1196

In The

Supreme Court of the United States

SECURITY EXCHANGE COMMISSION,

Appellant,

v.

CHARLES E. EDWARDS, ET. AL.

Appellees.

On Appeal from the 11th Circuit Court of Appeals
(From the United States District Court for the
Northern District of Georgia D.C.,
Case No. 00-02532-CV-JTC-1)

MOTION FOR LEAVE TO FILE OUT-OF-TIME AMICUS CURIAE BRIEF IN SUPPORT OF APPELLEES

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MEMORANDUM OF POINTS AND AUTHORITIES

Financial World Companies, Inc., a Colorado Corporation, Owners/Lessors, with stockholder interest(s) in ETS, Payphones, Inc., a corporation and DOES 15,000 similarly situated (hereafter sometimes referred to as "Financial World Companies"), Owners/Lessors "DOES 15,000", (collectively referred to as "Financial World Companies", hereby respectfully move for leave to file out-of-time the attached Brief Amicus Curiae in this case. The consent of the attorney for the Petitioner, Securities and Exchange Commission ("SEC"), was requested and was granted. The consent from the attorney for the Appellees, Charles E. Edwards, ETS Payphones, Inc., et. al., has also been obtained.

Financial World Companies' interest in this case arises from the fact that it and 15,000 people entered into a purchase/"leaseback" and lessor/lessee relationship based on the integrated written agreements (Exhibits 2 through 5) of the Amicus Curiae Brief herewith. The lessor/lessee relationship and agreements with Lessee ETS provided for the lessor, Financial World to have a dominant, controlling and reversionary interest while vesting the Lessee with a limited, subservient and possessory interest in certain property, strictly subject to full compliance with the subject Lease. The integrated leaseback agreements are commonly used to establish the reality of the relationships and control over the subject property.

Financial World Companies, and DOES 15,000, as Lessors, received the benefit of the services from ETS and PSA without losing control and the discretionary decision-making over their investments (payphones). Financial World Companies' interests and their positions were not asserted in the Unites States District Court for the Northern District of Georgia or the Eleventh Circuit Court of Appeals, as set forth in the Brief. The issue was not fully presented as to Financial World Companies' understanding that these were lease contracts which still provided it with full control over the

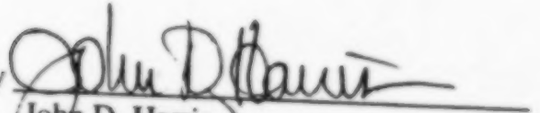
payphones and related equipment, and all aspects of the payphone, despite the fact that the payphones were leased back to ETS for management, in exchange for a fixed monthly lease fee. There was no discussion as to Financial World Companies' interest, as affected and protected under the Interstate Commerce Act, as leases, versus the improper interpretation of such leases as "investment contracts" by the United States District Court. Because ETS was ordered to stop making lease payments to Financial World Companies and DOES 15,000, also owners of the payphones, ETS had to stop the sale and leaseback of the new payphones and new telephone sites relative to the leases. Both ETS and PSA were thereafter forced to file a Voluntary Petition for Bankruptcy and Reorganization. Financial World Companies was left with no choice but to purchase the interests of ETS in bankruptcy in order to protect what little interests remained in their leases. Financial World Companies and DOES 15,000 have been damaged in the sum of millions of dollars.

In the instant case, the main issue in the Eleventh Circuit Court of Appeals was whether the leases constitute an investment contract under this Court's decision in Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). Neither the Eleventh Circuit Court of Appeals or the United States District Court for the Northern District of Georgia dealt with the interstate commerce issue or the issue of control as to the Financial World Companies' Lessors' knowledge, skill, and experience with the payphone equipment, maintenance, management, or location issues. These critical issues must be presented to this Court in relation to its decision in the SEC v. Howey Co. case and its impact on the continuity of the application of law under the interpretation of the Albanese v. Florida Nat. Bank of Orlando, 823 F.2d 408 (11th Cir. 1997) decision. Since it is likely that the Petitioner may pursue the same course of action by ignoring these key issues affecting Financial World Companies, as Owners herein, it is believed

that the Brief which the Amicus Curiae is requesting permission to file will contain a more complete argument on the constitutional issue affecting the pivotal issues of control and knowledge, skill, and experience, as the same relate to that issue. If this argument is accepted, it would be dispositive of the case. This brief clarifies issues left unresolved in the case of SEC v. Howie Co., and the Albanese v. Florida Nat. Bank of Orlando case, supra.

RESPECTFULLY SUBMITTED this 29th day of October, 2003.

HARRIS LAW FIRM, P.C.

By 

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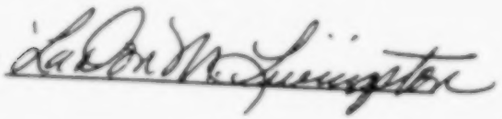
By 

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AMICUS CURIAE BRIEF OF FINANCIAL WORLD COMPANIES, INC. IN SUPPORT OF APPELLEES

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QUESTIONS PRESENTED FOR REVIEW BY AMICUS CURIAE IN SUPPORT OF APPELLEES

1. Whether the 11th Circuit Court of Appeals was accurate in distinguishing the definition of "investment contract" from a "lease", as Congress intended under the Securities Act of 1933, as amended, such that U.S.C.S. §77(b)(a)(1) and *SEC v. W.J. Howey Co. et. al.*, do not apply.

2. Whether the 11th Circuit Court of Appeals properly determined that the written and integrated "leaseback" agreements providing the Owner/Lessor with control involving their landlord-lessee type relationship was sufficient to distinguish it from of *SEC v. W.J. Howe Co., et al.* and 15 U.S.C.S. § 77(b)(a)(1) under the facts herein and why construing the "leaseback" as an "investment contract" would result in an undue burden on interstate commerce violating the Unites States Constitution.

PARTIES TO THE PROCEEDING

This Amicus Curiae Brief is filed by Financial World Companies, Inc. in support of Appellee(s) Charles E. Edwards, ("Mr. Edwards") who is the Defendant and Respondent in this case before the United States Supreme Court. In the underlying action, Mr. Edwards was the principal in several business entities and was the founder and majority stockholder of E.T.S. Payphones, Inc., a Georgia corporation, ("ETS") the lessee involved in the lease of the coin-operated telephones and the payphone equipment lease program. He was also the founder of Payphone Systems Acquisitions, Inc., a Georgia corporation (referred to herein as "PSA"). PSA was a wholly owned subsidiary of ETS. PSA purchased telephone equipment and locations, which were then sold at wholesale prices to certain distributors. He was also the principal owner of a company known as Twin Leaf, Inc., a Georgia corporation ("Twin Leaf"), which was a consulting company created to provide support services to ETS, a lessee and lessor. Mr. Edwards, ETS, PSA, and Twin Leaf were the Defendants in the underlying action filed in September, 2000 by the Securities and Exchange Commission (herein sometimes referred to as the "SEC") in the United States District Court for the Northern District of Georgia, D.C., in Case No. 00-02532-CV-JTC-1.

These Amicus Curiae are not parties in the underlying action but the underlying action directly affected their interests. Amicus Curiae, Financial World Companies" or "Financial World", a Colorado corporation, (herein sometimes referred to as "Financial World Companies, Inc." and other same or similarly situated persons involved with the Financial World Companies, Inc. entity were the Owners and Lessors who/which contracted (See Exhibits 1 through 5 attached) with Appellee ETS in the subject payphone

businesses. The Owners/Lessors generally consist of approximately 15,000 Payphone Owners. Their collective interests exceed Five Million Dollars ($5,000,000) of payphones which were leased to ETS Payphones, Inc. for management and other related services. Financial World Companies, Inc. and other similarly situated Owners/Lessors purchased ETS and PSA in the subsequent ETS and PSA bankruptcy matters. On August 13, 2003, Financial World Companies, Inc., on behalf of itself and DOES 1-15,000 similarly situated lessors, served upon the Securities and Exchange Commission, the United States Attorney General and the United States Department of Justice their Notice of Governmental Claim. Such claims are representative of the interests of more than 60,000 payphones with an approximate invested value of over $5,000,000, said payphones leased to ETS, and $210,000,000 in lease payments, all of which were directly affected by the Securities and Exchange Commission's actions.

STATEMENT PURSUANT TO RULE 37(6) OF THE SUPREME COURT RULES OF COURT

Amicus Curiae Financial World Companies, Inc., Owners/Lessors, as a representative of other same and similarly situated Lessors, did not receive any assistance from any party or monetary contribution toward the preparation or submission of this Amicus Curiae Brief from any person or entity other than from said Amicus Curiae itself and its members.

STATEMENT PURSUANT TO RULE 29.6 OF THE SUPREME COURT RULES OF COURT

Amicus Curiae Financial World Companies, Inc. and other similarly situated members it represents and for

whom/which it has filed this Brief were forced to purchase the interests of ETS in ETS' bankruptcy matter. They did so in order to protect what little interest(s) remained after the businesses of ETS and PSA failed. They are now shareholders and owners of ETS and PSA by virtue of a certain bankruptcy Settlement Agreement. Under that Agreement, Amicus Curiae Financial World Companies, Inc. and other similarly situated ETS / PSA stockholders represent approximately one hundred percent (100%) of the total payphones leased by ETS and represent ownership of 100% of the stock of ETS and PSA.

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II. Whether the 11th Circuit Court of Appeals properly determined that the written and integrated "leaseback" agreements providing the owner/lessor with control is sufficient to distinguish the lack of controlling *SEC v. W.J. Howe Co., et al.* and 15 U.S.C.S. in defining the payphone "leases" as "an investment contract" within the meaning of 15 U.S.C.S. § 77(b)(a)(1) under the facts herein and why construing the "leaseback" as an "investment contract" would result in an undue burden on interstate commerce violating the United States Constitution.

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OPINIONS BELOW

The Opinion of the 11th Circuit Court of Appeals, which reversed the District Court, is reported at 300 F.3d 1281 (2002). The order of the District Court granting the Securities and Exchange Commission's Motion for a Preliminary Injunction, which was later vacated by the 11th Circuit Court of Appeals, is reported at 123 F. Supp. 2d 1349 (2002).

JURISDICTION

The Judgment of the 11th Circuit Court of Appeals was entered on August 6, 2002. A Petition for Rehearing was denied on November 15, 2002. The Petition for a Writ of Certiorari was filed on February 13, 2003 and was granted by this Court on April 21, 2003. This Court has jurisdiction pursuant to 28 U.S.C. 1254(1).

STATUTORY AND CONSTITUTIONAL PROVISIONS INVOLVED

The United States Constitution provision involved is the Interstate Commerce Clause, Const. Art. I, Sec. 8. The Federal statute, 15 U.S.C. 776(a)(1) and (d), § 77(b)(a)(1), and § 78(c)(a)(10), which are provided in the Appendix to the Petition for Writ of Certiorari, are incorporated herein by this reference (Pet. App. 30a-31a).

STATEMENT OF THE CASE

Factual Background

Financial World Companies, Inc. and the other similarly situated Owners/Lessors of the payphones, (herein

collectively referred to as "Financial World" or "Financial World Companies, Inc." or "Financial World Companies"), submit their Amicus Curiae Brief in support of Charles E. Edwards ("Mr. Edwards"), E.T.S. Payphones, Inc. ("ETS"), Payphone Systems Acquisitions, Inc. ("PSA") and Twin Leaf, Inc. ("Twin Leaf"), (herein sometimes collectively referred to hereinafter as "Appellees"). Mr. Edwards was the principal in several business entities and was the founder and majority stockholder of ETS. Mr. Edwards was a member of the ETS Board of Directors and served as its Chief Executive Officer at all times referenced herein. ETS was incorporated to provide management services, including placement, advertisement, maintenance, coin collecting, and accounting for the subject Owners/Lessors and approximately 15,000 similarly situated Owners/Lessors. Financial World Companies, Inc. is a typical representative of said Owners/Lessors for this Amicus Curiae Brief. Mr. Edwards also founded PSA, a corporation. PSA was a wholly owned subsidiary of ETS. PSA purchased telephone equipment in locations which it then sold at wholesale prices to certain distributors. Mr. Edwards was also the principal owner of a company known as Twin Leaf, a Georgia corporation. Twin Leaf was a consulting company and was created to provide support services to ETS, the Lessors and Lessees. Financial World Companies, Inc. and other similarly situated persons/entities received benefits from the services provided by ETS and PSA.

Another company, unrelated to the entities identified herein, is an entity known as BEE Communications, Inc. ("BCI"). It sold payphone(s) and protective enclosure(s) and other items (hereinafter sometimes referred to as the "payphones", "equipment",and/or "additional equipment") and are more particularly set forth in Exhibits 2 through 5, attached hereto and incorporated herein by this reference.

For example, Exhibit 2 is a "Bill of Sale" which makes reference to Exhibit 3, an Equipment List, which describes the equipment as ten (10) units of operating payphone stations, telephone numbers, their exact locations, identified by unit and by payphone(s)' serial number. It is incorporated into Exhibits 2 through 5 by reference herein.

The Bill of Sale clearly indicates the total amount of the consideration the Grantee and, Owner, Financial World Companies, Inc., paid (for the payphones) to the Grantor/Seller BCI. It also is the actual conveyance, sale, transfer, assignment, deliverance, and grant of the payphone, and it forever vests and conveys all of the rights, title, and interests in the payphones and equipment, as indicated in the BCI Purchase Agreement (Agreement No. 25178) and the Equipment List (Exhibit 3). The Bill of Sale (Exhibit 2) also contained a warranty of merchantability (Id., ¶ 5) and contains the official gold seal of the Grantor, BCI, and is fully executed by the authorized persons. Further, the Bill of Sale contains all of the serial numbers to the payphones and equipment, matching those on the Equipment List (Id. 2 and 3). After Financial World Companies, Inc. purchased the telephone equipment in December 15, 1999, it entered into an agreement with ETS to lease back the payphone units, such that ETS would be bound by the specific terms and conditions of the Telephone Equipment Lease Agreement (herein referred to as the "Lease Agreement"and attached hereto as Exhibit 4). In pertinent part, the Lease Agreement provided, as follows:

a. The Lessee, ETS, agreed to lease the equipment from the Owner/Lessor Financial World Companies, Inc., subject to the Lease terms and conditions (Id. p. 1);

b. The Lease was in full force and effect for an initial

term of sixty (60) months ("the Initial Term"). Upon expiration of the Initial Term, the Lease will be automatically renewed for an additional sixty (60) months (the "Renewal Term") unless at least ninety (90) days prior to the end of the Initial Term either party gives notice to the other that it elects not to continue during the Renewal Term. The monthly rental payment for the equipment during the Renewal Term shall be the same as the existing rate under the Initial Term. Should the Lessor, Financial World Companies, Inc., chose to terminate the Lease and take possession of the equipment and location prior to the Lease expiration, it may do so with a ninety (90) day written notice to ETS (Exhibit 4, ¶ 2);

c. ETS shall pay a monthly rental fee to Owner/Lessor Financial World Companies, Inc. for the equipment at the rate of $82.00 per month per unit. The monthly rental payments, with the exception of the first one, shall be due on the first or fifteenth day of each succeeding calendar month in the amount stated and shall be sent by United States mail on the 1st or 15th day of each month unless the 1st or the 15th day falls on a Saturday or Sunday, in which event the check may be sent the following Monday (Exhibit 4, ¶3);

d. The Lease Agreement creates a lease of the equipment indicated on the Equipment List (Exhibit 3) and absolutely does not allow ETS to be deemed or construed to have acquired any right, title, or interest in the equipment or location; provided, however, if Financial World Companies, Inc. obtains an offer from any third party for the purchase of the equipment, then, and in that event, Financial World shall provide ETS with written notice of the proposed sale and terms thereof, and ETS shall have thirty (30) days from the receipt of such notice in which to give written notice to Financial World Companies, Inc. of its election to purchase

the equipment upon the same terms or conditions of any/said third-party offer. This is customarily known as a "Right of First Refusal" and is stated in most contracts of this nature. If ETS does not submit written notice within the subject thirty (30) day period, then the Owner/Lessor Financial World Companies, Inc. shall be free to sell its equipment pursuant to such third party offer. If ETS notifies Financial World Companies, Inc. of its election to purchase, then ETS shall have 180 days to close the sale from the date of the original notice it receives from Financial World Companies, Inc. (Exhibit 4, pars. 4 and 15). It is an unquestionable ownership right, title, and interest to the payphones' telephone number and the location that is as fully vested to the Owner/Lessor, Financial World Companies, Inc. (Id. ¶ 4);

e. This Lease is acknowledged as a "Net Lease," requiring ETS to bear the entire cost of using the equipment and maintaining same in accordance the terms and conditions of the Lease. ETS shall be responsible for and pay all expenses of insurance, repair, taxes, service, and maintenance of the payphones and the location; but ETS may be allowed, at its own cost and expense, to contract with any third parties to provide management, repairs, service, and maintenance to the payphones and for the location at its own cost (Exhibit 4, ¶ 5). **There are in excess of 1,600 third parties available to each and all of the Owner/Lessors for said purposes. (Decl. of Hooper at ¶ 8).**

f. ETS shall be responsible for selecting the location for installation of the payphone; and as the Lessee, it the sole authority and right to move the payphones to a new location should the original location prove to be unprofitable or prove to be in a high vandalism area. However, ETS must notify Financial World Companies, Inc. in writing in the event of a site exchange and Financial World Companies, Inc. will

receive the notification of the address of the new location. ETS shall assign the applicable location lease to Financial World Companies, Inc. by written Letter of Assignment (Exhibit 4, ¶ 6);

g. In the event Financial World Companies, Inc. terminates the lease prior to the expiration of the Term and elects to retain the payphones, ETS shall assign the applicable location lease to Financial World Companies, Inc. by a written Letter of Assignment between the parties; otherwise ETS shall retain the rights to the location (Exhibit 4, ¶ 6);

h. ETS shall indemnify and hold Financial World Companies, Inc. harmless from any and all loss, damage, liability, taxes and expenses (including, without limitation, reasonable attorneys fees) which Financial World Companies, Inc. shall incur as a result of (i) the loss of or damage to the payphone equipment and/or location because of fire, theft, collision, lightning, flood, windstorm, or any other casualty at any time during the "Term" of the Lease or (ii) the death of or injury to any person or damage to any property as a result, in whole or part, of the use or maintenance of the aforesaid at any time during the Term of the Lease (Exhibit 4, ¶ 7(a));

i. Lessee ETS must maintain insurance policies issued by an insurance company reasonably satisfactory to Financial World Companies, Inc. with all premiums prepaid for the coverage, insuring Financial World Companies, Inc. against the risks and hazards specified in ¶ 7(a)(i), with a minimum coverage of $100,000 for property damage, $500,000 for the death of or injury to any one person, and $2,000,000 for any one occurrence involving the payphone, equipment, or the location (Exhibit 4, ¶ 7(b));

j. If Lessee ETS fails to obtain the said insurance

coverage, it shall not affect ETS' obligations under the Lease; and the loss, damage, or destruction of the payphones or equipment shall not terminate the Lease (Exhibit 4, ¶ 7(c)). Financial World Companies, Inc. shall have the option to procure or maintain such insurance coverage for the account of ETS, and ETS shall reimburse Financial World Companies, Inc. within seven (7) days after receipt of any invoice for any payment made by Financial World Companies, Inc.. If ETS fails to reimburse Financial World Companies, Inc., it shall be deemed a default under Section 10 of the Lease. Such provision also triggers certain default remedies for Financial World (Exhibit 4, ¶¶ 7, (c) 10), as provided below;

k. Lessee ETS is required to pay all use taxes, personal taxes, property taxes, and any other taxes related to the payphone, equipment or site location (Exhibit 4, ¶ 8);

l. Only Lessee ETS has control of the payphones, equipment and location, but only as long as it is not in default of any of the terms and conditions of the Lease Agreement or as otherwise subject to the rights of Financial World Companies, Inc. (emphasis supplied) as set forth in the Lease (Exhibit 4, ¶ 9);

m. Lessee ETS shall comply with any and all laws and regulations applicable to the operation of the payphones equipment and the location and shall be solely responsible for the payment of any and all fines or penalties from its failure to comply therewith (emphasis supplied), (Exhibit 4, ¶ 9);

n. Lessee ETS shall maintain the payphones and equipment in good working order at the location or any other location where the payphones and equipment may have been relocated, as allowed under the Lease. ETS may add further parts or accessories to the payphones, provided any such

addition does not materially affect or materially impair the value of the payphone equipment or the location, and any such additions shall become the property of Financial World Companies, the Owner/Lessor (Exhibit 4, ¶ 9);

o. In the event Lessee ETS defaults under the Lease, it is responsible to pay all amounts that become due within twenty (20) days after receiving notice of such default from the Owner/Lessor, Financial World Companies, Inc., so as to cure the default (Exhibit 4, ¶ 10(a)(1) and (2)). If ETS files an involuntary petition in bankruptcy or insolvency under the reorganization provisions of any law, or a receiver is appointed for ETS or for the property of ETS, the Lease shall continue and remain undischarged or unstayed for an aggregate period of thirty (30) days. Thereafter, it shall be deemed in default under the Lease (Exhibit 4, ¶ 10(a); ¶(s) 3 and 4);

p. If Lessee ETS abandons the payphone, equipment, or location or discontinues operation of the payphones or fails to notify Financial World Companies, Inc. of any relocation within sixty (60) days, or fails to remove within thirty (30) days any mechanics' liens on the payphones or location for additional work performed, it shall be deemed in default under the Lease (Exhibit 4, ¶ 10(a); ¶(s) 5, 6, and 7). Such operates as an additional control device for Financial World Companies, Inc;

q. If Lessee ETS defaults under the said Lease, Financial World Companies, Inc. may terminate the Lease and utilize the self-help remedy of repossession of the payphones, equipment, and the location; and the same shall be deemed automatically assigned to the Owner/Lessor without demand or legal process and ETS shall be liable to Financial World Companies, Inc. for any deficiencies between the amount of the rental agreement due under the Lease Agreement, and the

cost of re-letting the payphones and equipment, including all reasonable attorneys fees and costs incurred (Exhibit 4, ¶ 10(b)(1) and (2));

r. Further, Financial World Companies, Inc. and others similarly situated shall have other rights and control of and under the Lease, such as the right to inspect the payphones, equipment, and location at any time (Exhibit 4, ¶ 12), the right to sell the payphones, equipment, and/or the location at any time (Exhibit 4, ¶ 15), the right to dispute resolution of any of the Lease provisions and the right to request a temporary restraining order, preliminary injunction, or similar equitable relief dispute shall be settled by arbitration in accordance with the American Arbitration Association. The Lease binds both parties, their heirs, executors, administrators, successors and assigns (Exhibit 4, ¶(s) 22 and 23).

Also, the parties executed and agreed to be bound by the "Option to Sell Agreement" (hereafter sometimes referred to as the "Option Agreement") dated December 15, 1999. The Option Agreement provides that Financial World Companies, Inc., as the Owner/Lessor, has the right to require ETS to purchase the equipment prior to or upon termination of the Lease Agreement (Exhibit 5, ¶ 4) for the purchase price of Seven Thousand Dollars ($7,000.00) per unit. The Option Agreement also provides Financial World Companies, Inc. and others with dispute resolution procedures under the rules of the American Arbitration Association (Exhibit 5, ¶ 7).

The facts set forth above are provided from the personal knowledge of Mr. Frank G. Hooper, President and CEO of Financial World Companies, Inc., who executed each of the agreements, (Exhibits 1 through 5), in his capacity as an Owner/Lessor herein. See Hooper Declaration ¶ 4. Since the date the parties entered into these numerous agreements,

(Exhibits 1 through 5), the Lessors regularly received the benefits of those agreements until approximately September of 2000, as more fully explained below.

Proceedings in Other Courts

In or about September, 2000, the Securities and Exchange Commission ("SEC") filed an SEC securities violation action against ETS in the United States District Court for the Northern District of Georgia, D.C., Case No. 00-02532-CV-JTC-1, claiming that the integrated written agreements (Exhibits 1through 5) constituted regulated security investment contracts which had not been registered by ETS and that ETS was in violation of federal securities laws. It immediately sought a preliminary injunction from the subject United States District Court alleging ETS sold securities in violation of the registration and anti-fraud provisions of 15 U.S.C. §§ 77(e)(a), 77(e)(c), 77(q)(a), 78(j)(b), and under 17 Code of Federal Regulations § 240.10(b)(5) and requested that the District Court enter a preliminary injunction in favor of the SEC. That same United States District Court then improperly determined that it had jurisdiction over the SEC action and granted a preliminary injunction enjoining Mr. Edwards and ETS from alleged future violations of the securities laws. It also froze Mr. Edwards assets and ETS' assets. ETS and PSA were forced to file a Voluntary Petition for Bankruptcy and Reorganization under the Federal Bankruptcy Act because ETS was compelled to stop making the lease payments to the telephone Owners/Lessors, Financial World Companies, Inc. and those above-referenced 15,000 other similarly situated Owners/Lessors, including those represented by this Amicus Curiae Brief. Because of the SEC's acts and conduct, ETS was also compelled to stop its program of honoring the buy-back guarantees, pursuant to the written contracts (Exhibits1

through 5). Further, ETS was required to stop the sale and lease-back of new payphones and new telephone locations relative to the Lease Agreement. As a further result of the SEC's actions, ETS' financing capabilities were shattered, hastening its demise. Financial World Companies, Inc. and other similarly situated Lessors, were forced to exchange their payphones, etc. for the lesser valued stock of ETS in bankruptcy. Financial World Companies, Inc., took this action to try to protect what little equity and interest which remained for the Owners/Lessors of the payphones, equipment, and locations. Anyone involved with ETS and PSA were considered to be involved and engaged in widespread fraud. Such had the effect of impugning the reputation of not only ETS and PSA, but also of Financial World Companies, Inc. and all other similarly situated persons who once supported and/or continued to support Mr. Edwards, ETS, and PSA and their positions that no Securities and Exchange Act or other violation(s) were being committed by ETS and others. See Declaration of Hooper at ¶ 7, 9.

ETS and PSA and others appealed the United States District Court's decision in favor of the SEC to the 11th Circuit Court of Appeals. They analyzed the United States Supreme Court case of *Securities and Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946) and argued that it and the 11th Circuit Court of Appeals case of *Albanese, et al. v. Florida National Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987) supported their position against the SEC. Albanese, supra., analyzed what constituted an "investment contract" as a security, pursuant to the *SEC v. Howey* case and the three-pronged test thereunder. After the 11th Circuit Court of Appeals applied the *SEC v. Howey, supra.*, analysis and the law of *Albanese et al. v. Florida National Bank of Orlando* to this case, it concluded that the District Court, in its analysis of ETS' integrated written Agreements (Exhibit 2 through 5),

did not constitute an "investment contract". The 11th Circuit Court then reversed the Judgment of the District Court for the Northern District of Georgia, D.C., and vacated the preliminary injunction in favor of ETS, and related parties. The SEC then filed a Petition for Certiorari to this Court, and this Court accepted same.

This case fundamentally concerns whether the integrated written agreements, (Exhibits 1 through 5) provided [control] and [ownership] to Financial World Companies, Inc. and others, as the Owners/Lessors of the payphones, telephone numbers, equipment, and locations. It also concerns the District Court Decision concerning chilling effect that District Court Decision has on interstate commerce by categorically deeming that all lease and/or leaseback contracts are "investment contracts" under the Securities and Exchange Act, supra. Financial World Companies, Inc. and others assert that after the United States Supreme Court reviews the facts herein and applies the applicable law to those facts that the Supreme Court will be compelled to sustain the 11th Circuit Court of Appeals decision in favor of ETS et. al., Respondents, herein.

SUMMARY OF THE ARGUMENT

Congress specifically omitted the words "lease" and "leaseback" from (A) the definitions of "security" in Section 2(a)(1) of the Securities and Exchange Act of 1933, as amended, (herein sometimes referred to as the "Securities Act"), from (B) 15 U.S.C. 77(b)(a)(1) and specifically from (C), the general term of "investment contract". Leases and leaseback agreements are fundamentally not investment contracts. To include leases and leaseback agreements as investment schemes or investment contracts, within the definition of the Securities Act, would impair and impugn the

Interstate Commerce Clause. It would result in a chilling effect on interstate commerce throughout the United States, rendering vague and ambiguous the terms "lease" and "leaseback" in every State definition in every commercial and private lease and/or leaseback contract.

Further, the factual and legal effect of "control" items in this case, which are enforceable under the lease and leaseback agreements, distinguish the agreements from "investment contracts" under the Securities Act.

ARGUMENT

I. WHETHER THE 11TH CIRCUIT COURT OF APPEALS WAS ACCURATE IN DISTINGUISHING THE DEFINITION OF "INVESTMENT CONTRACT" FROM A "LEASE", AS CONGRESS INTENDED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, SUCH THAT U.S.C.S. §77(b)(a)(1) AND *SEC V. W.J. HOWEY CO. ET. AL.*, DO NOT APPLY.

This Supreme Court, in its long standing decision of *Securities and Exchange Commission v. W.J. Howey Co. et al.*, 328 U.S. 293 (1946), analyzed an offering of units of a citrus grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds of same to the purchaser/investor and developed a three-pronged test which has been followed in nearly every Circuit Court of Appeals in the United States.[1] The *Howey* decision by this

[1] According to Shepherd citation, bound Vol. 1 from 1946 through Sept. 1, 2003, Vol. 102, No. 17 through Vol. 102, Sept. 15, 2003, No. 18, the *Howey* case has been cited as followed and controlling over 150 times in the last 56 years. It has been rarely dissented to and even more rarely questioned in its judgment. The cases which distinguish it seem to distinguish it only on the issue of control, which is at issue here.

Court also carefully analyzed the issue of how much [control] the purchaser or investor actually had under the totality of the circumstances of the contractual dealings. It made a special note that the facts were undisputed and that W.J. Howey Co. and Howey In-The-Hills Service, Inc. are Florida corporations under the "direct common control and management of the Howey Companies, Inc.." it also noted that the Howey Companies, Inc. owned the large tracts of citrus acreage and that during the past several years had planted about 500 acres of citrus annually, keeping one-half of the groves for itself and offering the other half to the public to allegedly "help us finance additional development" (Id. p. 293). Further, the Decision noted that the various written land sale contracts with the Howey Companies, Inc. were entered into with the purchasers and that upon full payment of the purchase price, the citrus land is to be conveyed to the purchaser by a warranty deed. All the purchaser actually received, however, under the purchase contract, was a sliver or strip of land arranged so that an acre consisted of a row of 48 citrus trees which were contained in a tract which was not separately fenced. The sole indication of separate ownership is found in small landmarks intelligible only through a plot book of record (Id. p. 293). The management contract affecting the land sales agreement was of a 10-year duration, without an option of cancellation and gave the Howey In-The-Hills Service Inc. a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the Howey Company was given full discretion and authority over the cultivation,

growth, harvest and marketing of the crops (Id., p. 296). This Court then wisely noted the Howey Company was a significantly dominant player, well established in the citrus business, and maintains a large force or skilled personnel and a great deal of equipment, which included 75 tractors, sprayer wagon(s), fertilizer trucks and the like. "Without the consent of the company, the landowner or purchaser has no right of entry to market the crop; thus, there is ordinarily no right to specific fruit. The company is accountable only for an allegation of the net profits based upon a checkmate at the time of picking. All the produce is picked by the respondent companies, which do business under their own name." (Id. p. 296). Of great importance, the Court noted, "The purchasers for the most part are non-residents of Florida. They are predominately business and professional people who lack the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees." (Id. at p. 296).

In the ETS case before the bench, however, the "leverage and control" features should be factually analyzed. The parties complied with the terms and conditions of the integrated lease written agreements. These agreements controlled the operative functions of the leases between Lessor and Lessees therein.[2] Leases are not mentioned by Congress in the classes of securities which are identified as exempted securities under 15 U.S.C. § 77(c)(a). The first part or test of the analysis set forth by this Court under the Howey case is for the Court to look for the substance of the written agreements which control the interests of the parties

[2] Congress is structuring the limited parameters of The Securities and Exchange Act of 1933. 15 U.S.C.S. §§ 77(b) defines the term "security" and specifically omits the word "lease" and/or "leaseback" contacts from the Act. See 15 U.S.C.S. § 77(b)(a)(1) [Definitions].

and to disregard form over substance, **placing the emphasis on the economic reality of the control feature based on the written terms and conditions between the parties which are legally enforceable in a judicial setting.** *SEC v. Howey* at p. 298 emphasis supplied).

Analysis of the substance of Exhibit 2, the "Bill of Sale." The Bill of Sale has the legal effect of transferring and vesting complete ownership of the payphones and equipment to the Owner/Lessor, i.e., Financial World Companies, Inc., as follows:

> "For a consideration of the payment of $70,000.00 for ten (10) payphones, as indicated on the BCI Purchase Agreement #25178 and other good and valuable consideration to Grantor (BCI) in hand paid by Grantee (Financial World Companies, Inc.) and/or before the execution and delivery hereof, the receipt and sufficiency whereof are hereby acknowledged, Grantor has conveyed, granted, bargained, sold, transferred, assigned, delivered, and confirmed, and by this Bill of Sale does convey, grant, bargain, sale, transfer, assign, deliver, and confirm unto Grantee its successors and assigns, forever, all of that certain equipment consisting of payphone(s) and protective enclosure(s) (hereinafter referred to as the "equipment") as more particularly set forth on Exhibit A to be sent to you by the designated management company." (Exhibit 1, ¶ 2).

> "To have and to hold all of said equipment hereby assigned, transferred, and conveyed unto Grantee, its successors and assigns, forever." (Exhibit 2, ¶ 3).

"Grantor covenants and agrees with Grantee to warrant and defend title to the equipment sold to Grantee against all and every persons whomsoever and warrants that the title transferred is good and its transfer rightful." (Exhibit 2, ¶ 4).

Moreover, the Bill of Sale provides a Warranty of Merchantability and Fit for the Particular Purposes Sold representation. It is said to be "free of any material defect for the period of sixty (60) days following the date" the parties entered into the said Purchase Agreement #25178 (Id. ¶ 5). The Bill of Sale referencing the Purchase Agreement states that the Grantor does execute and deliver and will cause to be done, executed, and delivered all such further acts, transfers, assignments, and conveyances for the better assuring, conveying, and confirming to the Grantee, its successors and assigns, all of the equipment hereby assigned, transferred, and conveyed as Grantee, its successors or assigns as it shall reasonably require. (Id. ¶ 6).

Finally, the Bill of Sale referencing such Purchase Agreement states, "This Bill of Sale and the covenants and agreements herein shall be binding upon Grantor, its successors and assigns, and shall inure to the benefit of Grantee, its successors and assigns." (Exhibit 2, ¶ 7). It also contains the specific serial numbers and identification of equipment referenced above. Exhibit 3 is the Payphone and Equipment List. The Equipment List indicates the payphones, equipment, location, and corresponding serial numbers of same, subject to the Telephone Equipment Lease Agreement. (Exhibit 4) herewith.

The Bill of Sale effectively vests all rights, title, and interest in the payphones and the equipment for the consideration indicated in the Bill of Sale, pursuant to the BCI

Purchase Agreement #25178. The BCI Purchase Agreement is legally subject to recordation by its very terms under the recording laws of the appropriate state. The Bill of Sale specifically requires BCI, the "Grantor," to "warrant and defend title to the equipment sold to Financial World Companies against all persons whomsoever and warrants that the title transferred is good and its transfer rightful." (Exhibit 2, ¶ 4). The Bill of Sale is executed by the president of BCI, making it enforceable against it. In the first part of this analysis, BCI, the agent acting on behalf of ETS, has fully vested by the Bill of Sale all rights, title, and interest in Financial World Companies, Inc. This includes legal possession of the payphones, equipment, and location placing the aforesaid control in the hands of Financial World Companies, Inc.

The Telephone Equipment Lease Agreement (Exhibit 4), identifies who holds ownership rights control/power and power over the payphones, equipment and location of same. Note that it provides that all rights, title, and interest to the payphones, equipment, and location is vested in Financial World Companies, the "Lessor", under the Lease Agreement" (Exhibit 4), supra. ETS, the "Lessee," only has the right to control the payphone, equipment, and any additional equipment added on by the Lessee (ETS) [if] it is in full compliance with all of the Terms and Conditions of the Agreement, as set out above (Exhibit 4). This is a not a standard Lease Agreement. It is specific as to a number of terms, including, but not limited to the following: the duration of the Lease, amount to be paid monthly to Lessors in rental installments, and the fact that the Lease Agreement does not contain nor shall it be construed in any manner whatsoeve: that ETS acquires any right, title or interest in the payphones, equipment, or additional equipment or location except (1) a Right of First Refusal and an Option to Sell

Agreement under paragraphs 15 and 16 of the Agreement (Exhibit 4, ¶(s) 4, 15, 16). ETS is responsible for all taxes and other charges and must provide full indemnification and insurance coverage for the payphones, equipment, the location in the substantial amounts of $10,000 for property damage, $500,000 for the death of or injury to any one person, and $2,000,000 for any one accident or occurrence naming Financial World Companies, Inc. as the insured and beneficiary to protect it under the Lease (Exhibit 4, pars. 7 and 8). The Lease Agreement is specific in that it identifies who has actual and enforceable control over the payphones, equipment, and additional equipment (Exhibit 4, ¶ 9). Lessor Financial World Companies, Inc. has the controlling legal rights to seven (7) methods of defaulting ETS in the event ETS violates any of the provisions of the Lease (Exhibit 4, ¶ 10(a) 1-7). These include self-help repossession provisions, allowing it to repossess the equipment from ETS without notice. Moreover, ETS' rights under the Lease "automatically terminate," and "ETS shall have no further rights to use" the payphones, equipment, additional equipment, or the location of such equipment. The repossession by Financial World Companies, Inc. may occur without demand or legal process" and it may "retake and retain" all of the payphones, equipment, additional equipment and the location, and all of the aforesaid "shall be deemed automatically assigned to Lessor; and Lessee shall have no further rights to such location, whether such rights existed during the Term hereof or arose or were to arise following termination or expiration" of the Lease (Exhibit 4, ¶ 10(b) [Remedies] (1) and (2)). The Lease provides for the Lessor to recover all of its attorneys fees and costs and to pursue ETS for any deficiency between the amount of rental due plus the reasonable cost to the Lessor recovering and re-letting the equipment, including reasonable attorneys fees and costs and

the rental sums received by the Lessor from such re-letting (Exhibit 4, ¶ 10(b)(2)).

Upon the expiration or earlier termination of the Lease, "ETS shall return" the payphones, equipment, additional equipment, and the location to Financial World Companies, Inc. in good operating condition, normal wear and tear excepted (Exhibit 4, ¶ 11). The Lessor has the right to sell all of the equipment, additional equipment, and the location to any third party with written notice of the proposed sale terms to ETS, who then has thirty (30) days from the date of its receipt of such notice of intent to sell to execute an election to purchase the equipment upon the same terms and conditions of the third party's offer (Exhibit 4, ¶ 15). The Owner/Lessor also has the equitable right to specific performance under the Lease in addition to the right to seek an injunction to prevent breaches of the provisions of the Agreement. And, the Owner/Lessor, like Financial World Companies, Inc., has the stated right to specifically enforce the Agreement in any action instituted in any Court of the United States or any State having jurisdiction over the parties, in addition to any other remedy to which it may be entitled at law or equity relating to the payphones, equipment, additional equipment, and the location, all pursuant to the Lease (Exhibit 4, ¶ 21). The Lease requires that disputes be arbitrated under the rules of the American Arbitration Association (Exhibit 4, ¶ 22) except an Interlocutory Hearing for an action for a temporary restraining order, preliminary injunction, or similar equitable relief relating to the Lease can be employed/used by the Owner/Lessor to control the subservient Lessee's limited control of payphones, equipment and location subject to the Lease. (Id., ¶ 22(a)). The Lease also provides that the Lease "shall be binding upon the parties hereto and their heirs, executors, administrators, successors, and assigns...." (Exhibit 4, ¶ 22(b)).

Regarding the issue of whether ETS has control over the subject assets, rendering the Lease Agreement an investment contract under the second prong of this Court's analysis, it is clear that the Court cannot reach such a conclusion. The overwhelming evidence benefits the Lessor, Financial World Companies, on the issue of control of the payphones, equipment, additional equipment, and the location, as set forth in Exhibits 1 through 5 herewith. ETS cannot be held liable for an actual violation of federal securities laws unless ETS is the dominate and controlling entity which had actual control over the specific transactions complained of, i.e., control over the payphones, equipment, additional equipment and the locations to same.

In substance, legal control (Exhibits 2 through 5) relates to "actual control". Actual control is both firmly established and provided for under the terms of the Lease, distinguishing the Lease from an investment contract. (Exhibits 2 through 5).

The parties' lease agreements provided that the Owner/Lessor "retains sole and complete discretion in determining whether or not to exercise "the Option Agreement", as discussed previously herein.

ETS entered into the purchase/leaseback agreements in the State of Georgia. Financial World Companies asserts that a distinction under the totality of the facts here is drawn between the "lessor-lessee" relationship. Note that Appellant SEC attempts to use these terms interchangeably. This is an error. They are not interchangeable. They are not the same. Here, the lease agreements, Exhibits 2 through 5, place Financial World Companies and 15,000 similarly situated Owners of the payphones in the dominate contractual position of "Lessor" and place ETS as "Lessee", similar to that in a

"Landlord-Tenant" relationship. The former ("Lessor-Lessee") relationship refers only to the contract and the latter "(Landlord-Tenant") refers to both to the contract and to the change in possession of the property. The **rights** of a Lessor and Lessee in control of the property are **subject to** the lease and are divided: the lessee has a **"Lease"**, an agreement which gives rise to a **relationship** whereby one owning property (real or personal) grants to another the right to possess, use and enjoy it for a specified period of time in exchange for periodic payment of a stipulated price, referred to as rent. A **"Leaseback"** is a prearranged transaction whereby [ETS] transfer/sells property and (after, ETS "Leases" it back from the purchaser [Financial World Companies, Inc.]. Black's Law Dictionary, 5th Ed. (1983) p.p. 461 and 462. possessory interest, and the Owner/Lessor has the reversionary interest in the property under the lease. See *Midcontinent Broadcasting Co. v. Dresser Industries, Inc., 486 F. Supp. 858 (1980); Viterbo v. Friedlander, 120 U.S. 707, 30 L.Ed. 776, 7 S. Ct. 962 (1886);* The relationship of Lessor-Lessee is not coexistent with that of creditor and debtor (or Investor-Investee); the latter type of the relationship arises only upon the failure of the lessee to pay rent under the lease. *Evans v. Kroh, 284 S.W. 2d 329, 58 ALR 2d 1449 (1955), cited in 49 Am. Jur. 2d 49 (1995).*

Under Georgia's law, which the parties agreed would control the transactions, (Exhibit 4, ¶ 20), "lease" and "leaseback" arrangements are specifically defined and are commonplace commercial events between the government of the State of Georgia and the commercial/private sector in and around Georgia. *Civil Code 3 11-2A-103 (1); Section 50-23-7 and 50-32-51;and Georgia Attorney General Opinions No(s). 2002-3 (June 27, 2002; 98-10 (May 16, 1998); U95-21 (Oct. 3, 1995); 95-25 (May 18, 1995); 95-41 (Oct. 5,*

1995); 95-45 (Dec. 25, 1995); general reference http://www.legis.state.ga.us/cgi-bin/htsearch.

The integrated lease agreements specifically transferred actual possession and control of the payphones, equipment, etc. to the lessee ETS, subject to ETS' required compliance with the Lease (Exhibit 4). The Owner/Lessor, Financial World Companies, Inc., had a reversionary interest and actual control of the payphones etc. upon the default of the lessee - ETS. Under the lease (Exhibits 1 through 5), the actual relationship of lessor/lessee existed, as a matter of law, rather than that of an investment contract relationship. Such relationships are mainstream activities under the Interstate Commerce Clause of the United States Constitution (supra.) and are fully supported by not less than 1,600 other payphone management companies throughout our nation. Decl. of Hooper ¶ 8.

Therefore, the second prong of the Howey test supports that the ETS' agreements are not an investment contract under the applicable law.

II. WHETHER THE 11TH CIRCUIT COURT OF APPEALS PROPERLY DETERMINED THAT THE WRITTEN AND INTEGRATED "LEASEBACK" AGREEMENTS PROVIDING THE OWNER/LESSOR WITH CONTROL INVOLVING THEIR LANDLORD-LESSEE TYPE RELATIONSHIP WAS SUFFICIENT TO DISTINGUISH IT FROM OF *SEC V. W.J. HOWE CO., ET AL.* AND 15 U.S.C.S. § 77(b)(a)(1) UNDER THE FACTS HEREIN AND WHY CONSTRUING THE "LEASEBACK" AS AN "INVESTMENT CONTRACT" WOULD RESULT IN AN UNDUE BURDEN ON

INTERSTATE COMMERCE VIOLATING THE UNITES STATES CONSTITUTION.

In ETS' case before the Bench, the District Court turned to the 1987 decision of *Albanese v. Florida National Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987) for guidance. It stated,

> "Even if the Agreement's words did grant the investor sufficient potential control over their ice machines to prevent the Agreements from being securities, the record demonstrates that, in fact, any such control was illusory because Plaintiffs had no realistic alternative to allow PCI to manage their investments. See *Gordon,* 684 P.2d at 741; *Williamson*, 645 F.2d at 419-24." (Id. at p. 412).

> "There is no evidence in the record that there were other companies which Plaintiff could hire to manage their ice cream machines. The only reference in the record to another such company is *Jeffries Cabinets*, which one of the Plaintiffs mentioned in a deposition. Even that company, according to the deposition, was only a service company and did not offer the wide range of management services that PCI offered... The record demonstrates, however, that Plaintiffs did not rely upon PCI actually to service the machines or to collect the proceeds. Rather Plaintiffs relied upon PCI's **management** of the ice machines. That management involved all of the components of directing the enterprise, whether it be placing the machines or repairing and maintaining them. Although Plaintiffs might in a technical sense have been able to contract with the same companies with him PCI contracted for services, there is no indication

that this was a realistic alternative. Even though some Plaintiffs were experienced businessmen, none of them had any experience in placing, managing, or servicing ice machines. *Cf., W.J. Howey Co.*, 328 U.S. at 295, 66 S.Ct. at 1101."

The Declaration of Hooper and Exhibits 1 through 5 defeat any conclusion that control was illusory because Financial World Companies and other similarly situated Owners/Lessors possessed at all times full, written and legal power and control over the phones and products and this fact directly equates to actual, physical possession and control of the payphones, equipment, additional equipment, and the location over the same. Unlike the 11th Circuit's *Albanese* case, the Owner/Lessor herein had total, real and legal power, under the integrated contracts, to control the payphones, etc., including the location of the payphones, etc. (Exhibit 4, ¶ 6 [Location]). Exhibit 4, ¶ 6 regarding [Location] of the Lease Agreement provides that ETS, the Lessee, shall be responsible for selecting the location for installation of the equipment and has the right and sole authority to move the equipment to a new location should the original location prove to be unprofitable or prove to be in a high vandalism area, constituting the main reasons for a different location mutually acknowledged by the Lessor and Lessee. However, "Lessor will be notified in the event of site exchange and will receive notification of the address of the new location" (Id. ¶ 6). ETS/Lessee "shall assign the applicable location lease" to Owner/Lessor, Financial World Companies, by a "written letter of assignment between the parties" (Id. ¶ 6) transferring that right to control the location lease to Owner/Lessor. As customary in all lease and purchase/leaseback agreements, whether it involves the leasing of real estate, heavy equipment, vehicles, medical equipment, aircraft, or as here, payphones, equipment, additional equipment (Id., ¶ 9), the

equipment shall at all times during the Term hereof be under the sole and absolute control of Lessee [ETS], **subject to the rights of the Lessor** (Exhibit 4) (emphasis in underline and bold supplied). Upon expiration or earlier termination of the said Lease Agreement, ETS is required to return the payphones and equipment, etc. to Financial World Companies in good operating condition, normal wear and tear excepted (Id. ¶ 11). It is the Lessor, at all times, who\which retains the legal power, as set out in the Lease Agreement, to sell the equipment, additional equipment, or/and the location to ETS or any other third party (Id. pars. 12, 14, 15, and 16) after the agreed notice to Lessee ETS (Id. ¶ 19) of the lease. The strength and dominance of the Option Agreement (Exhibit 5), incorporated into the Lease Agreement (Exhibit 4), inures to the benefit of the Owner/Lessor, who retains sole and complete discretion in determining whether to exercise the options under it (Exhibit 5, ¶ 1). In fact, the Option Agreement vests dominant control to the Lessor, who is "entitled to require Lessee to purchase the equipment prior to or upon termination of the Lease Agreement" (Id. 5, ¶ 4) and is further subject to the Lease Agreement which vest controlling power to the Owner/Lessor (Id.).

When the SEC interfered into ETS' payphone businesses, said leases were in good standing, and forcing ETS, had made/paid all of the payments due and owing to the Lessors under the Lease. Said another way, the Lessors herein never incurred a loss until the SEC improperly intervened, restraining ETS's ability to make payments on the leases and forcing the Lessors into a position of having no control over the leases, forcing all of the leases into default, and ETS ultimately, into bankruptcy. This involuntary default on all of the leases quite obviously caused the Lessor to incur losses on the Leases. Lessors, like Financial World Companies, Inc. took losses, not because of any acts or

conduct of ETS/PSA or Twin Leafs, but only because of the government's improper and wrongful interference with the private and valid Lessor/Lessee relationships and binding Lease Agreement (Id. fn.3),[3] existing in Interstate Commerce. See Decl. of Hooper ¶ 9.

These are, without a doubt, binding agreements giving real, actual and dominate power or influence over contract activities and relationships of an entity is deemed a "control person." *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 548 (9th Cir. 1986), one who formulates and directs corporate policy or who is deeply involved in the important business affairs of a corporation. *State ex rel. McLeod v. C&L Corp., Inc.*, 280 S.Ct. 519, 313 S.E.2d 334, 341 (S.C. App. 1984). Note that Exhibits 4 and 5 are signed by the Chief Executive Officer ("CEO") of each company. Financial Wold CEO Mr. Charles E. Edwards signed as the CEO for the subservient Lessee, ETS. Mr. Frank G. Hooper signed the written integrated agreements on behalf of Financial World as its CEO. The Lessor/Lessee relationship is completely controlled by the lease agreements, including the Telephone Lease Agreement (Exhibit 4) and the Option Agreement (Exhibit 5). ETS has no actual power which may exceed the legal power of the written agreements between the parties. Owner/Lessor, Financial World Companies, Inc., is the "control person" with the dominant rights which may be

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[3] **"Binding Agreement"** means a contract which is enforceable, such as an offer to buy or sell when the person to whom it is made accepts it and communicates his acceptance and consideration is exchanged. **Bill of Sale** in contracts means a written agreement, formerly limited to one under seal by which a person assigns or transfers his rights to or interests in goods and personal chattels to another - a legal document which conveys title from Seller to Buyer. *Black's Law Dictionary*, 6th Ed. (1990).

enforced, including but not limited to, full injunctive power, even if and while there is a dispute between the parties relating to any aspect of the agreements **concurrent** with enforcement of specific performance of the agreements (Exhibit 4, pars. 21 and 22(a) and Exhibit 5, pars. 3, 4, 5, 6, and 7(a)). The Bill of Sale (Exhibit 2) bears the official and original gold seal authenticating the vesting of ownership and the guarantee of rights, titles and interest to the Grantee, Financial World Companies, Inc. and divests the same interests from ETS or its agent, BCI. Of these three agreements, it is clear that the Bill of Sale, Lease Agreement, and Option Agreement allowed that the Owner/Lessor , could be empowered, in reality, in the Lessor/Lessee relationship (supra.) Moreover, **the over 30 years of leasing** experience of Financial World Companies, Inc. was sufficient to make an objective, reasonable, and prudent business decision as to whether to enter into such agreements or allow or continue to allow ETS/PSA or Twin Leaf to have any influence or involvement relating to the payphones, equipment, additional equipment, and/or location, all of which are subject to the parties' agreements. See Decl. of Hooper, and Exhibits 2 through 5. Financial World Companies degree and level of control, as Lessor, over the subservient ETS, as a matter of law, is sufficient to disqualify the Agreements as" investment contracts"under the Securities Act, and applicable law. See *Howey* and *Albanese*, (supra.) ETS only has the limited right to control, and only as to the equipments' location subject to its being in good standing under the Lease Agreement and subject to conditions of notice; otherwise ETS will be in danger, of triggering the rights of Lessor, Financial World Companies, as to utilization of the self-help, repossession, specific performance, and injunctive relief remedies under the Lease Agreement (Exhibit 4, pars. 6, 10(a)(6), and (b)(1)(2), 12, 17, 22, and Exhibit 5). Again, if ETS defaults on the Lease, Financial World Companies, like all other

Owners/Lessors, may activate their right to utilization of the self-help, repossession, specific performance, and injunctive relief remedies under the Lease Agreement (Exhibit 4 ¶ 6, and (b)(1)(2), 12, 17, 22, and Exhibit 5) to fully control the property and the Lessor/ETS.

The Lease Agreement also compels ETS to remove any mechanics' liens on the equipment or additional equipment for any work performed on same (Exhibit 4, ¶ 10(7)) or constitutes a default, triggering the remedies under paragraph 10 and 22 of the Lease Agreement. This absolutely establishes, as a matter of law and fact, that the "right to inspect", is accompanied by full "right to control" the physical control, operation, service, sale, resale, possession, and the rights to utilize self-help repossession and/or the judicial system to enforce those rights of control under the Bill of Sale, Lease Agreement and Option Agreement(Exhibit 2 through 5). Decl. Hooper, ¶ 6.

These [rights] are not illusory. They are real and legally enforceable, placing the case outside of the parameters of the control of the *Howey* case, supra.

Further, Lessee ETS was required to maintain substantial indemnification and insurance coverage to protect Owner/Lessor Financial World Companies from any loss or damage from the use or maintenance of the payphones etc. All taxes whatsoever are the legal obligation of ETS (Exhibit 4, ¶ 8). No illusory promise, appointment, or condition exists in the integrated agreements (Exhibit 2 through 5).

The written and binding agreements between the parties clearly did not leave to ETS any choice regarding performance or non-performance. Such would be typical of an illusory promise or agreement. There were no alternative

choices which ETS could have selected which would have rendered the integrated agreements, just illusory promises. There were no terms in the parties' agreements which left ETS' performance optional; nor was there any provision of supposed promise entirely within ETS' discretion, pleasure, or control under the agreements. As set forth herein, Financial World Companies and the other similarly situated Lessors/Owners at all times maintained the dominant legal and actual control over the payphones, equipment, additional equipment, and the location, with the exception of a change of location, which allowed ETS to move the subject payphones and related equipment to a new location upon the occurrence of two strictly identified conditions: (1) "The original location proved to be unprofitable" or (2) "the original location proved to be in a high vandalism area" (Exhibit 4, ¶ 6). The integrated agreements (Exhibits 1 through 5) eliminate any conclusion that the obligations of ETS or the benefits of control by the Owner/Lessor was illusory.

The integrated agreements providing full non-illusory control to the Owner/Lessor relationship with Lessee ETS is part of the normal and traditional contractual dealings of the nationwide flow of interstate commerce with real life and real world objectives. Owner/Lessors were fully aware of their individual/collective options to select from the over 1,600 other payphone managers, etc. nationwide rather than choose ETS. Decl. of Hooper, ¶ 8. They chose ETS. The integrated agreements are clear, definite and certain. They do not contain any vague or ambiguous language. They include the requirement to arbitrate all disputes pursuant to the American Arbitration Association provisions. (Exhibit 4 ¶ 22).

The agreements establishing the actual "control" **for** the parties are what they are: Purchase and leaseback

agreements transferring possession to ETS to the agreements (Exhibit 2 through 5), and a revisionary interest to Financial World Companies and 15,000 similarly situated Owner/Lessors. The contracts memorialize the Owner/Lessor's and Lessee's commitment to adhere to the integrated contracts regime of balancing the legal rights, disputes and the control issues affecting the parties' relationships. **"That regime has a real world objective; it is not designed for regulation of a game lacking practical consequences."** *C and L Enterprises, Inc. v. Citizen Band Potawatomi Indian Tribe of Oklahoma 532 U.S.. 292 (April, 2001) [Upholding arbitration provision against defense of sovereign immunity].*

The parties' commitment to achieve the goals of the agreements real world objective were non-illusory and these same parties were actually receiving the benefits of the relationship of Lessor-Lessee, as they mutually intended. The integrated arguments were designed for regulation of the said relationship, having practical business consequences with potential disputes (Exhibits 2 through 5) and understood as such. To the real world's end, the Lease and Option Agreement (Exhibits 4 and 5) specifically authorize judicial enforcement of the agreements through injunctive restraint/control, arbitration and adjudication (Exhibit 4, ¶'s 10, 11, 16, 17, 19, 21, 22 and 23; Exhibits 5 ¶'s 1-8) over the Seller/Lessee, ETS.

Therefore, the valid and enforceable integrated contracts would be rendered meaningless if misconstrued as "investment contracts" as the S.E.C. has already done. Suffice it to say the third element of the *Howey* test cannot be satisfied according to these facts.

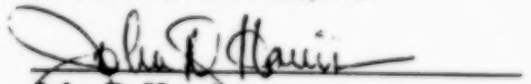
This Court is respectfully requested to sustain the Decision of the 11th Circuit Court of Appeals which determined the parties' agreements were not investment contracts, which would fall under the *Howey* test interpreting the subject Securities Act.

CONCLUSION

For the reasons stated, the Judgment of the 11th Circuit Court of Appeals should be sustained. The *Howey* test is inapplicable.

Dated this 29th day of October, 2003

HARRIS LAW FIRM, P.C.



John D. Harris
Randy D. Lang
Attorneys for Financial World Companies, Inc.

EXHIBIT 1

EXHIBIT 1

DECLARATION OF FRANK G. HOOPER IN SUPPORT OF AMICUS CURIAE BRIEF FOR RESPONDENTS ETS PAYPHONES, INC. ET AL.

1. The facts herein are of my own personal knowledge. If called upon to testify to those facts, I could and would do so competently. I am over the age of 18 years. I am a non-party in the underlying action but have the same or similar interests of Respondent, ETS, Inc., as a typical representative of thousands of Lessors representing millions of dollars of capital and income to the Lessors whose interests were affected by the Securities and Exchange Commission in this case.

2. I am the Chief Executive Officer and a Member of the Board of Directors of Financial World Companies, which was formed in Colorado in January, 1973. Financial World Companies is a multi-faceted financial company. The company has had diverse interests in life insurance, health insurance, leasing, employee benefit plans, accounting, lending, and other income yielding assets. It also has experience in management of assets, and control of other diverse investments. I do not use the word "investment" in a legal sense but in an ordinary business sense. It covers an extremely broad range of business-related activities, which include investment for profit, tax benefits, and other types of yields or benefits.

3. In particular, Financial World Companies has had a strong interest in the purchase leaseback type business arrangements because of the reasonable, profitable yield and tax benefits and the very diverse and broad range of products which

can be **controlled** by the Owner, which then becomes the Lessor in the contractual arrangement. It is this aspect of legal control over the product, item or thing ("Product") which is expressly stated in the written contracts entered into by the parties. Such written contracts include the lease agreements like the ones involving Mr. Edwards, ETS and PSA. When the contracts are integrated, like they are in our transactions with ETS, they provide the required control to the Owner/Lessor in these lease-type arrangements. The purchase/leaseback arrangements also provide for a consistent, profitable yield, maximum tax advantages, credit profile, leverage, market dominance, flexibility with the Product, and other beneficial features, whether it involves a short-term or long-term purchase leaseback business. Other business benefits and leverages relating to purchase/leaseback of the Product are that they are generally easier to monitor while being used by the Lessee, and the arranging and entering of the contractual relationship between the Lessor and Lessee can be done from a central location and both monitored and controlled nationwide. This is especially true with regard to payphones.

4. I have personal knowledge and familiarity with the attached Exhibits 2 through 5, the Bill of Sale, the Equipment List, the Telephone Lease Agreement, and the Option Agreement which are attached to the Amicus Curiae Brief and incorporated herein by reference. As the CEO of Financial World Companies, I carefully analyzed the existing market, possible market trends, and the upside and downside of purchasing payphones from BEE Communications, Inc. ("BCI"). BCI sold payphone(s) and protective enclosure(s) and other items (hereinafter sometimes referred to as "the payphones" or "equipment", as more particularly set forth in Exhibits 2-4). These Exhibits 2 through 5 are an integrated series of documents consisting of the written contractual

agreements between the Owner/Lessor and the Lessee. Each Owner/Lessor clearly understood the degree of control they had over the lessee and the Product involving the purchase/leaseback provisions of the written contracts before purchasing the subject payphones. Financial World is an example of one of the hundreds of these payphone owners which had no difficulty understanding the basic concepts of the purchase/leaseback, ownership, and control over the payphones. In fact, many have previously leased some sort of asset or product in their lifetime. I never encountered a single adult Owner/Lessor that did not understand what a payphone is and how it works and the way users use payphones, including the potential for abuse and vandalism. All of the owners of the payphones understood the general dynamics of how the purchase/leaseback and the contents of the working written agreements protected their interests, and mine, as well.

5. As the CEO of Financial World, I personally undertook and completed the due diligence inquiry regarding E.T.S. Payphones, Inc. ("ETS"), Payphone Systems Acquisitions, Inc. ("PSA"), Twin Leaf, Inc. and Mr. Charles E. Edwards prior to purchasing the Product and entering the purchase/leaseback type contracts. After a reasonably diligent and prudent investigation of Mr. Edwards, ETS, PSA, and Twin Leaf, and after consulting with attorneys and other knowledgeable persons with the purchase/leaseback agreements and the accompanying documentation, I was and still am convinced that at all times before and after entering into the subject lease-related contracts that we did and continued to maintain complete legal control, including rights of actual control over the Product as set forth in Exhibits 2-5 herein.

6. In fact, during the entire term that Financial World and the other similarly situated payphone were a part of the written contracts with ETS etc., we received a reasonable rate

of return, as expected. Such returns were similar to other leasing activities we had previously and continued to be engaged in regarding other products. The payphone Product was probably one of the best, because you could realize a net return within a very short period of time. It could also be determined whether or not the payphone was located in a good public area and used by the public with little or no vandalism. If the particular location chosen from the onset proved to be unproductive, the payphone could simply be relocated, with little out-of-pocket expense, paid for by ETS. Remember that ETS, as the Lessee, did not make any money unless the payphone itself produced money. Pursuant to Exhibits 2-5, as usual, the Lessee, ETS, was completely responsible for the payphones in every respect. This included insuring the Owners/Lessors against losses, paying for maintenance, and the responsibility for the taxes as well. Any transfer of interest was always subject to written approval and a separate written agreement between us as the Lessors and ETS. All aspects of the payphone benefitted the Owner/Lessor over the Lessee (ETS), as specifically set forth in this Amicus Curiae Brief and said Exhibits. I also add that there was not a lot of hoopla, fancy words, or intricate marketing that related to or was connected with the payphone purchases and the leaseback written contracts. The primary element scrutinized, as in all purchase/leaseback business deals, is whether or not the Owner/Lessor, through the written documentation, has a secured interest which is valid and legally enforceable over the payphone or Product in the event the Lessee/ETS, defaults under the agreements. This element was satisfied. In fact, in my opinion, the agreements identified as Exhibits 2 through 5 gave us as the Owner/Lessor more legal control, lien rights and other protections, including the right to exercise self-help repossession, the right to sell the payphones, telephone numbers, equipment, and location to other third-parties and limited ETS

as the Lessee under the terms, conditions, and duration of the Lease. To my knowledge, ETS never misrepresented any aspect of the integrated written agreements and kept all commitments under the agreements with us. In fact, we were very happy with the purchase/leaseback business involving Mr. Edwards, ETS, PSA, and Twin Leaf and the payphone business.

7. To my knowledge, the only times that Financial World Companies and the other 15,000 similarly situated Owners/Lessors became disappointed, and unhappy with ETS were on two occasions. The first was in or about September, 2000 when the Securities and Exchange Commission filed a lawsuit alleging securities violations against ETS in the United States District Court for the Northern District of Georgia, D.C., Case No. 00-02532-CV-JTC-1, claiming that our leases and the integrated written documentation (Exhibits 2-5) constituted a regulated security investment which had not been registered by ETS and that ETS was allegedly in violation of the securities laws. Thereafter, the Securities and Exchange Commission obtained a preliminary injunction, freezing all of ETS' assets, forcing ETS to file a Petition for Bankruptcy and Reorganization. ETS was forced to stop making the lease payments to the telephone owners, Financial World Companies and the 15,000 similarly situated Owners representative of this Amicus Curiae Brief. The second occasion of our disappointment resulted when Financial World Companies and the other 15,000 similarly situated Owners/Lessors were forced to exchange their leaseback and Product interests for common stock in ETS in an attempt to mitigate their losses caused by the Securities and Exchange Commission. However, there was no way to mitigate the impact that the Securities and Exchange Commission had on ETS and its reputation that anybody involved and engaged in business with ETS/PSA or Twin Leaf was engaged in widespread fraud. This had the effect of impugning and destroying the reputation of the

individual Owners/Lessors, which included Financial World Companies, but also all other similarly situated Owners who supported and continue to support Mr. Edwards, ETS, PSA, and Twin Leaf..

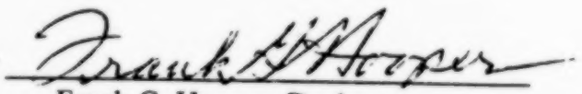
8. It was also clearly understood that there were other business management organizations available to the Owners/Lessors in the event we chose to no longer do business with ETS. These include management companies which were very well known in the industry, such as Alfa-Tel Com, Inc., Trans-Star Communications, Inc., Select Payphones of America, and numerous other operating businesses located in Florida, New York, California and otherwise across the United States. We could have terminated the purchase/leaseback written contracts with ETS, pursuant to the terms of the agreements at its expiration, or in the event ETS defaulted on any lease and we could have started doing business with a number of other management companies. Please note that these other companies were not fly-by-night companies. They were well known in the payphone management business industry in which ETS, PSA, and Twin Leaf had to compete for our business.

9. I believe that on behalf of, Financial World Companies, the 15,000 other similarly situated payphone Owners/Lessors, and myself that this Amicus Curiae Brief is submitted on our behalf in good faith to explain more of the factual details which were not fully considered in the earlier proceedings in the United States District Court or the of the 11th Circuit Court of Appeals. This is a very important issue before this Court, affecting thousands of people, representing millions of dollars which were prematurely cut-off and destroyed by the Securities and Exchange Commission. We are aware the Securities and Exchange Commission usually acts so as to protect the public against investment artifices and

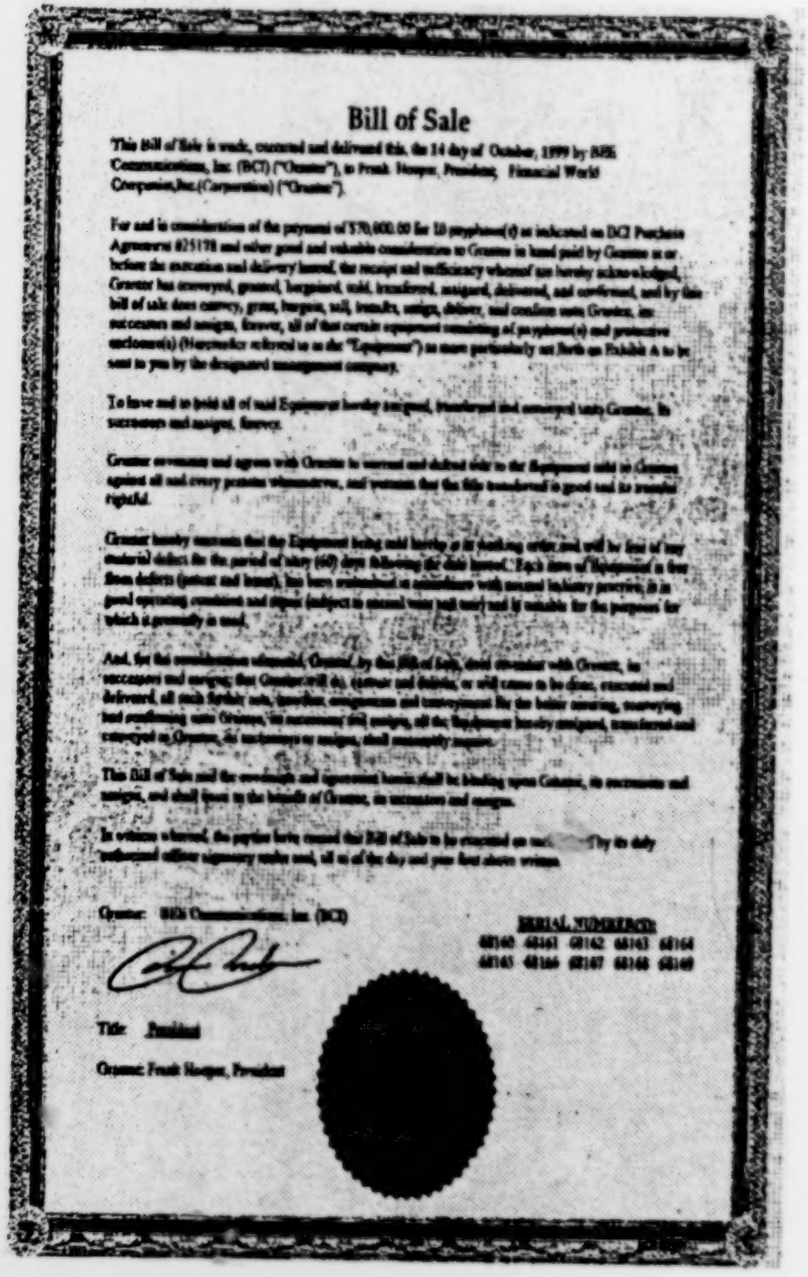
schemes, and we appreciate that fact. However, this was not an investment artifice or scheme but was a legitimate business purchase/leaseback deal which was financially benefitting the Owner/Lessor; until the Securities and Exchange Commission became involved and mistakenly terminated ETS' business activities.

I declare under penalty of perjury the foregoing is true and correct to the best of my knowledge.

Dated: October 28, 2003

By 

Frank G. Hooper, Declarent



Bill of Sale

This Bill of Sale is made, executed and delivered this the 14 day of October, 1999 by BIS Communications, Inc. (BCI) ("Grantor"), to Frank Hooper, President, Financial World Corporation,Inc.(Corporation) ("Grantee").

For and in consideration of the payment of $70,800.00 for 10 prepayment(s) as indicated on DCI Purchase Agreement #25178 and other good and valuable consideration to Grantor in hand paid by Grantee at or before the execution and delivery hereof, the receipt and sufficiency whereof are hereby acknowledged, Grantor has conveyed, granted, bargained, sold, transferred, assigned, delivered, and confirmed, and by this bill of sale does convey, grant, bargain, sell, transfer, assign, deliver, and confirm unto Grantee, its successors and assigns, forever, all of that certain equipment consisting of prepayment(s) and protective enclosure(s) (Hereinafter referred to as the "Equipment") as more particularly set forth on Exhibit A to be sent to you by the designated management company.

To have and to hold all of said Equipment hereby assigned, transferred and conveyed unto Grantee, its successors and assigns, forever.

Grantor covenants and agrees with Grantee to warrant and defend title to the Equipment sold to Grantee against all and every persons whomsoever, and warrants that the title transferred is good and its transfer rightful.

Grantor hereby warrants that the Equipment being sold hereby is in working order and will be free of any material defect for the period of sixty (60) days following the date hereof. Each item of Equipment is free from defects (patent and latent), has been maintained in accordance with normal industry practice, is in good operating condition and repair (subject to normal wear and tear) and is suitable for the purposes for which it presently is used.

And, for the consideration aforesaid, Grantor, by this Bill of Sale, does covenant with Grantee, its successors and assigns, that Grantor will do, (cause and deliver, or will cause to be done, executed and delivered, all such further acts, transfers, assignments and conveyances for the better assuring, conveying and confirming unto Grantee, its successors and assigns, all the Equipment hereby assigned, transferred and conveyed as Grantee, its successors or assigns, shall reasonably require.

This Bill of Sale and the covenants and agreements herein shall be binding upon Grantor, its successors and assigns, and shall inure to the benefit of Grantee, its successors and assigns.

In witness whereof, the parties have caused this Bill of Sale to be executed on its behalf by its duly authorized officer signatory under seal, all as of the day and year first above written.

Grantor: BIS Communications, Inc. (BCI)

SERIAL NUMBERS:
68160 68161 68162 68163 68164
68165 68166 68167 68168 68169

Title: President

Grantee: Frank Hooper, President

EXHIBIT 2

BEST AVAILABLE COPY

Lease: 10437
Date: 04/18/00

THE EQUIPMENT
(Exhibit "A")

The equipment described herein constitutes ten (10) units of operating payphone stations.

Unit 1: Location: OLDE BRAINERD SHOPPING CENTER #2 — Serial #: 68160
4011 BRAINERD RD
CHATTANOOGA, TN 37411
Phone #: 423-629-8035 Tone

Unit 2: Location: HURT TUESDAY — Serial #: 68161
131 CROSSROADS BLVD
CARY, NC 27511
Phone #: 919-854-9246 Tone

Unit 3: Location: E-Z SERVE #503 — Serial #: 68162
910 FIRST AVE SW
HICKORY, NC 28601
Phone #: 828-304-9958 Tone

Unit 4: Location: WESTERN CAROLINA RESCUE/ WOMEN — Serial #: 68163
235 PATTON AVE
ASHEVILLE, NC 28801
Phone #: 828-252-9829 Tone

Unit 5: Location: DAIRY QUEEN/ BRAZIER — Serial #: 68164
2270 S RIDGEWOOD AVE
SOUTH DAYTONA, FL 32119
Phone #: 904-756-9710 also to provide the incoming calls

Unit 6: Location: EPIPHANY THRIFT STORE — Serial #: 68165
5120 S RIDGEWOOD AVE
DAYTONA BEACH, FL 32127
Phone #: 904-756-9898 Disconnected

Unit 7: Location: E-Z SERVE #4328 #1 — Serial #: 68166
HWY 69 & 90
GRAND RIDGE, FL 32442
Phone #: 850-592-1167 Tone

Unit 8: Location: E-Z SERVE #4328 #2 — Serial #: 68167
HWY 69 & 90
GRAND RIDGE, FL 32442
Phone #: 850-592-1168 Tone

EXHIBIT 3

Lease: 10437
Date: 04/18/00

T H E E Q U I P M E N T
(Exhibit "A")

Unit #: Location: E-Z SERVE #7366 #3 — Serial #: 68168
3494 OLIVE RD
PENSACOLA, FL 32504
Phone #: 850-478-8803 T-n-c

Unit 10: Location: E-Z SERVE #7276 #1 — Serial #: 68169
1600 S HWY 29
GONZALEZ, FL 32580
Phone #: 850-937-9515 T-n-c

Lease: 10437
Date: 12/29/99

T H E E Q U I P M E N T
(Exhibit "A")

The equipment described herein constitutes ten (10) units of operating payphone stations.

Unit 1: Serial #: 68160
Unit 2: Serial #: 68161
Unit 3: Serial #: 68162
Unit 4: Serial #: 68163
Unit 5: Serial #: 68164
Unit 6: Serial #: 68165
Unit 7: Serial #: 68166
Unit 8: Serial #: 68167
Unit 9: Serial #: 68168
Unit 10: Serial #: 68169

Telephone Equipment Lease Agreement

Lease Number: 10437

THIS AGREEMENT is made and entered into this 15th day of December, 1999, by and between ETS Payphones, Inc., a Georgia corporation (hereinafter as "LESSEE") and FINANCIAL WORLD COMPANIES INC (Corporation) (hereinafter "LESSOR").

Witnesseth:

WHEREAS, LESSOR, as owner of ten (10) unit(s) of the telephone EQUIPMENT described on Exhibit A, attached hereto and by reference made a part hereof (the "EQUIPMENT") desires to lease said EQUIPMENT to LESSEE and LESSEE desires to lease said EQUIPMENT from LESSOR, all upon the terms and subject to the conditions hereinafter set forth.

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for good and valuable consideration, the receipt and sufficiency whereof are hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. **LEASE OF EQUIPMENT.** Subject to the conditions herein, LESSOR hereby leases the EQUIPMENT to LESSEE and LESSEE hereby leases the EQUIPMENT from LESSOR.

2. **TERM.** This lease shall commence (the "Commencement Date") as of the date provided above and shall remain in full force and effect for an Initial Term of sixty (60) months thereafter (the "Initial Term"). Upon the expiration of said Initial Term, this lease shall be automatically renewed, for an additional Renewal Term of sixty (60) months (the "Renewal Term") unless at least ninety (90) days prior to the end of the Initial Term, either party gives written notice to the other that said party elects not to continue during the Renewal Term. The Initial Term and the Renewal Term are hereinafter collectively deemed the "Term" of this lease. The monthly rent payment for the EQUIPMENT during such Renewal Term shall be the same as the existing rate under the Initial Term. Should LESSOR choose to terminate this lease and take possession of the EQUIPMENT and LOCATION prior to the lease expiration, LESSOR may do so with a ninety (90) day written notice.

3. **RENT.** LESSEE shall pay monthly rental to LESSOR for the EQUIPMENT at the rate of $82.00 per month per unit. The first monthly rental payment shall be due on the "Commencement Date." All subsequent monthly rental payments shall be due on the 1st or 15th day of each succeeding calendar month in accordance with the "Commencement Date" through the Term hereof.

   Note: LESSOR Rental checks shall be sent out by U.S. Mail and shall be sent on the 1st or 15th day of each month. However, should the 1st or 15th of the month fall on a Saturday or Sunday, the checks shall be sent the following Monday.

4. **TITLE.** This Agreement creates a lease of the EQUIPMENT. Nothing contained herein shall be deemed or construed as enabling LESSEE to acquire the right, title or interest in the EQUIPMENT or LOCATION, except as set forth in Sections 15 and 16 hereof.

5. **NET LEASE.** Except as expressly provided herein, the parties hereto expressly agree to and acknowledge that this is a "Net Lease" requiring LESSEE to bear the entire cost of using the EQUIPMENT and LOCATION through the Term of this lease. LESSEE shall be responsible for, and shall pay all expenses of, insurance, repair, service and maintenance of the EQUIPMENT and of the

EXHIBIT 4

LOCATION. LESSEE may, at LESSEE's expense, contract with third parties to provide such repair, service and maintenance.

6. **LOCATION.** The location of the EQUIPMENT shall be set forth on Exhibit A. LESSEE shall be responsible for selecting the location for installation of the EQUIPMENT. Lessee has the right and sole authority to move EQUIPMENT to a new location should the original location prove to be unprofitable or prove to be in a high vandalism area. LESSOR will be notified in the event of site exchange and will receive notification of the address of the new location. LESSEE shall assign the applicable location lease to the LESSOR by a written letter of assignment between the parties. In the event that LESSOR terminates the lease prior to the expiration of the Term and elects to retain the EQUIPMENT, LESSEE shall assign the applicable location lease to the LESSOR by a written letter of assignment between the parties; otherwise LESSEE shall retain the rights to the location.

7. **INDEMNIFICATION AND INSURANCE.**

a. LESSEE shall indemnify and hold LESSOR harmless from and against any and all loss, damage, liability and expense (including, without limitation, reasonable attorney's fees) which LESSOR shall sustain as a result of (i) the loss of or damage to the EQUIPMENT because of fire, theft, collision, lightning, flood, windstorm, or any other casualty at any time during the Term hereof, or (ii) the death of or injury to any person or damage to any property as a result, in whole or in part, of the use or maintenance of the EQUIPMENT at any time during the Term of this Lease.

b. LESSEE's obligations pursuant to Section 7a above shall be deemed satisfied if LESSEE obtains and maintains in full force and effect throughout the Term hereof, at the sole cost and expense of LESSEE, a policy or policies of insurance issued by an insurer reasonably satisfactory to LESSOR, with premiums prepaid thereon, insuring LESSEE against the risks and hazards specified in Section 7a(i) hereof with minimum coverage of $100,000 for property damage ($500,000 for the death of or injury to any one person) and $2,000,000 for any one accident or occurrence.

c. LESSEE's failure to obtain the insurance coverage specified in Section 7b hereof shall not affect LESSEE's obligations under this lease. The loss of, damage to or destruction of the EQUIPMENT shall not terminate this Lease; nor to the extent that LESSOR is actually compensated by insurance paid for by LESSEE, as herein provided, relieve LESSEE from LESSEE's liability hereunder. Should LESSEE fail to so procure or maintain the insurance required under this Section 7, then LESSOR shall have the option, but not the obligation, to procure or maintain such insurance coverage for the account of LESSEE, and in that event, LESSEE shall reimburse LESSOR within seven (7) days after receipt of any invoice for any payment made therefore by LESSOR. Failure to so reimburse LESSOR shall be deemed a default under the terms of Section 10 hereof.

8. **TAXES AND OTHER CHARGES.** LESSEE shall pay, when due, any and all use taxes, personal property taxes and any and all other taxes which may be imposed by the ownership, possession, use or operation of the EQUIPMENT at any time during the Term hereof or which are levied against or measured by the gross receipts delivered to LESSOR as a result of the payment of rent by LESSEE hereunder.

9. **USE, OPERATION, ALTERATIONS AND ADDITIONS.** The EQUIPMENT shall at all times during the Term hereof be under the sole and absolute control of LESSEE, subject to the rights of LESSOR in the event of a default by LESSEE as provided herein. LESSEE shall comply

with any and all laws and regulations applicable to the operation of the EQUIPMENT, and shall be solely responsible for the payment of any and all fines or penalties resulting from its failure to comply therewith. LESSEE shall maintain the EQUIPMENT in good working order at the location identified on Exhibit A, attached hereto, at all times throughout the Term hereof or at any other location where the EQUIPMENT may have been relocated. LESSEE may from time to time add further parts or accessories to the EQUIPMENT, provided any such addition does not materially affect or materially impair the value of the EQUIPMENT. Any such additions shall become the property of the LESSOR.

10. **DEFAULT AND REMEDIES**

a. **DEFAULT.** The occurrence of any one of the following events shall constitute an event of default by LESSEE:

1. A default by LESSEE in the payment of any amount due hereunder as and when the same shall become due and the continuance of such default for a period of more than twenty (20) days following LESSEE's receipt of written notice of such default requiring the same to be cured; or

2. A default by LESSEE in the performance of any of its material obligations under this Lease and the continuance of such default for a period of more than thirty (30) days following LESSEE's receipt of written notice of such default requiring the same to be cured; provided, however, that if more than thirty (30) days are reasonably required in order to cure any such default, then no default shall be deemed to have occurred so long as the curing of such default is commenced by LESSEE within such thirty (30) day period and LESSEE thereafter diligently prosecutes the curing of such default to completion; or

3. Whenever an involuntary petition shall be filed against LESSEE under any bankruptcy or insolvency law or under the reorganization provisions of any law or like import, or a receiver of LESSEE of or for the property of LESSEE shall be appointed without the acquiescence of LESSEE and such situation under this section 10a-3 shall continue and remain undischarged or unstayed for an aggregate period of thirty (30) days (whether or not consecutive) or shall not be remedied by LESSEE within thirty (30) days; or

4. Whenever LESSEE shall make an assignment of the property of LESSEE for the benefit of creditors, shall file a voluntary petition under any bankruptcy or insolvency law, or whenever any court of competent jurisdiction shall approve a petition filed by LESSEE under the reorganization provisions of the United States Bankruptcy Act or under the provisions of any law or like import; or

5. The abandonment of the EQUIPMENT by LESSEE or the discontinuance of the operation of such EQUIPMENT by LESSEE; or

6. The failure to notify LESSOR of any relocation within sixty (60) days; or

7. The failure of LESSEE to remove within thirty (30) days any mechanics liens on the EQUIPMENT for additional work performed on such EQUIPMENT.

b. **REMEDIES.** Upon the occurrence of an event of default under Section 10a above which is continuing and remains uncured, then LESSOR may, at its option, during the continuance of such event of default:

1. Terminate this lease by written notice to LESSEE and recover from LESSEE damages incurred by reason of such default, including the reasonable costs of recovering the EQUIPMENT and reasonable attorney's fees relating thereto, in which event LESSEE shall immediately surrender the EQUIPMENT to LESSOR, and if LESSEE fails to do so, LESSOR may take possession of the EQUIPMENT; and in that event, any rights to the EQUIPMENT that LESSEE may possess pursuant to this lease shall automatically terminate; LESSEE shall have no further right to use of the EQUIPMENT; LESSOR may, without demand or legal process, retake and retain the EQUIPMENT; all rights of LESSEE in and to the location of the installed EQUIPMENT shall be deemed automatically assigned to LESSOR; and LESSEE shall have no further rights to such location whether such rights existed during the Term hereof or arose or were to arise following termination or expiration hereof; or

2. Without terminating this lease, enter upon the location thereof and take possession of the EQUIPMENT and thereupon relet the EQUIPMENT, as LESSEE's agent, at the best price obtainable by reasonable efforts, and in such event, LESSEE shall be liable to LESSOR for any deficiency between (i) the amount of rental due hereunder plus the reasonable cost to LESSOR of recovering and reletting the EQUIPMENT, including reasonable attorney's fees, and (ii) the rental received by LESSOR from such reletting.

11. **SURRENDER.** Except as set forth herein, upon the expiration or earlier termination of this lease, LESSEE shall return the EQUIPMENT and LOCATION to LESSOR in good operating condition, normal wear and tear excepted.

12. **RIGHT OF INSPECTION.** LESSOR shall have the right at all times throughout the Term hereof to inspect the EQUIPMENT whenever and wherever the same shall be located.

13. **WARRANTIES AND CLAIMS THEREUNDER.** LESSOR makes no warranty or representation, expressed or implied, with respect to the EQUIPMENT; provided, however, that the EQUIPMENT shall be subject to any standard warranty of the manufacturers of such EQUIPMENT or components thereof. LESSOR hereby appoints LESSEE as its agent and attorney-in-fact throughout the Term hereof to assert and enforce, at LESSEE's sole expense, any claims LESSOR may have as owner of the EQUIPMENT against any vendor, manufacturer or supplier with respect thereto.

14. **ASSIGNMENT.** LESSEE shall have the right to assign or sell any of its rights hereunder. LESSOR shall have the right to sell or assign its rights hereunder, including any or all of LESSOR's right, title and interest in and to the EQUIPMENT and location and the rent reserved herein. In the event of such assignment by LESSOR, the assignee thereof shall thereupon acquire all rights and remedies possessed by or available to LESSOR. Upon receiving proper notice of any such assignment, LESSEE shall thereafter make any and all rental payments as therein directed.

15. **RIGHT OF FIRST REFUSAL.** In the event LESSOR obtains an offer from a third party for the purchase of the EQUIPMENT, then LESSOR shall thereupon provide LESSEE with written notice of the proposed sale and terms thereof. LESSEE shall thereafter have thirty (30) days from the date of its receipt of such notice in which to give written notice to LESSOR of its election to purchase the EQUIPMENT upon the same terms and conditions as the third-party offer. If LESSOR does not

receive written notice of such election from LESSEE within such thirty (30) day period, then LESSOR shall be free to sell the EQUIPMENT pursuant to such third-party offer. Should LESSEE notify LESSOR of its election to purchase, then LESSEE shall have one hundred eighty (180)days to close sale from the date of the original notice.

16. **OPTION TO SELL AGREEMENT.** Should LESSOR choose to sell the equipment to the LESSEE prior to or upon the end of the Term of the Lease, then LESSOR shall execute the Option To Sell Agreement attached hereto and by reference made a part hereof as Exhibit B. The terms and conditions of the Option to Sell Agreement shall govern the purchase by the LESSEE of the EQUIPMENT. LESSEE shall have one hundred eighty (180) days from the date of receipt of the original written notice to purchase said EQUIPMENT.

17. **PERSONAL PROPERTY:** The EQUIPMENT is and at all times throughout the Term hereof shall remain personal property, even if all or any portion of the EQUIPMENT becomes affixed or attached in any matter whatsoever to any real property.

18. **ACKNOWLEDGMENT OF DISCRETION.** LESSOR represents and warrants that (a) LESSOR is free to enter into agreements with parties other than LESSEE for the economic exploitation of the EQUIPMENT; (b) LESSOR was not required to enter into this lease as a condition to purchasing the EQUIPMENT; and (c) LESSOR has freely and voluntarily entered into this lease and acknowledges that LESSOR is not entering into or executing this lease in reliance upon any promise, representation or warranty not contained herein.

19. **NOTICES.** Any and all notices required or permitted hereunder shall be notarized in writing and sent to the intended recipient, addressed to its address set forth below, either by registered or certified mail, return receipt requested, postage prepaid, overnite delivery service, or personal delivery. Each such notarized notice shall be effective (a) if given by mail, as of three (3) business days after such notice or communication is deposited in the United States Mail; (b); if sent for overnite delivery via Federal Express or other reputable national overnite delivery service, one (1) business day after such notice or delivery is entrusted to such service, with recipient signature required; or (c) if personally delivered, when delivered at the address of the intended recipient. Any party may change the address to which notices or other communications hereunder are to be delivered by giving the other party notice in the manner set forth herein. Any notice required to be made within a stated period of time shall be considered timely mailed if deposited before midnight of the last day of the stated period.

20. **GOVERNING LAW.** This Agreement shall be governed by and construed in accordance with the laws of the State of Georgia.

21. **SPECIFIC PERFORMANCE.** Each party acknowledges and agrees that the other party would be damaged irreparably in the event any of the provisions of this Agreement are not performed in accordance with their specific terms or otherwise are breached. Accordingly, each party agrees that the other party shall be entitled to an injunction or injunctions to prevent breaches of the provisions of this Agreement and to specifically enforce this Agreement and the terms and provisions hereof in any action instituted in any court of the United States or any state thereof having jurisdiction over the parties and the matter, in addition to any other remedy to which it may be entitled, at law or in equity.

22. **DISPUTE RESOLUTION CONTRACT PROVISION.**

a. **DISPUTE.** Any dispute, controversy, or claim of whatever nature (except an interlocutory hearing for an action for a temporary restraining order, preliminary injunction, or similar

equitable relief) asserted by any party against another party arising out of, or relating to, this Agreement or the breach hereof, shall be settled by arbitration, if requested, by any party pursuant to this Section 21. The arbitration shall be conducted by one (1) arbitrator, who shall be appointed pursuant to the Commercial Arbitration Rules of the American Arbitration Association ("AAA"). The arbitration shall be held in Atlanta, Georgia, and shall be conducted in accordance with the Commercial Arbitration Rules of the AAA, except that the rules set forth in this Section 21 shall govern such arbitration to the extent that they conflict with the rules of the AAA.

b NOTICE. Upon written notice by a party to another party of a request for arbitration hereunder, the parties shall use their best efforts to cause the arbitration to be conducted in an expeditious manner, with such arbitration to be completed within sixty (60) days after selection of an arbitrator. In the arbitration, Georgia law shall govern, except to the extent those laws conflict with the Commercial Arbitration Rules of the AAA and the provisions of this Section 21. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need. All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

23. MISCELLANEOUS. This Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject matter hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked. This Agreement shall not be modified or amended except in writing signed by both parties. This Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Agreement are inserted for convenience only and are not a part of the Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

Check one ☐ Individual ☐ Partnership ☒ Corporation ☐ Self-Directed IRA ☐ Trust ☐ Joint Tenancy with Rights of Survivorship ☐ Other:

LESSEE: ETS Payphones, Inc.	LESSOR: FINANCIAL WORLD COMPANIES INC
By: Charles G. Edwards	By: David B. Hayden, Pres.
Title: CEO	Title: President
Address: 561 Thornton Road, Suite K Lithia Springs, GA 30122	Address: 3500 ROLLING GREEN DR #O-53 FORT COLLINS, CO 80525
Telephone Number: (770) 819-1600	Telephone Number: (970) 225-2797
Date: December 15, 1999	Date: 12/15/1999

Option To Sell AGREEMENT

(Exhibit B to Telephone Lease Agreement)

THIS AGREEMENT is made and entered into as of the 15th day of December, 1999, by and between FINANCIAL WORLD COMPANIES INC (Corporation) (hereinafter referred to as "LESSOR"), and ETS Payphones, Inc., a Georgia Corporation (hereinafter referred to as "LESSEE").

THE PARTIES HERETO ACKNOWLEDGE THAT THIS AGREEMENT INURES TO THE BENEFIT OF LESSOR, AND THAT LESSOR RETAINS SOLE AND COMPLETE DISCRETION IN DETERMINING WHETHER OR NOT TO EXERCISE THE REQUIREMENTS HEREINAFTER SET FORTH.

WITNESSETH:

WHEREAS LESSOR is the owner of ten (10) unit(s) of pay telephone Equipment (the "Equipment") pursuant to that certain PURCHASE AGREEMENT dated October 14, 1999, as reflected on Invoice Number 25178 related thereto; and

WHEREAS, LESSOR and LESSEE have entered into that certain Lease Agreement (the "Lease Agreement") dated December 15, 1999 bearing Lease number 10437, pursuant to which LESSEE has LEASED the Equipment from LESSOR; and

WHEREAS, pursuant to the Lease Agreement, LESSOR is entitled to require LESSEE to purchase the Equipment prior to or upon termination of the LEASE AGREEMENT; and

WHEREAS, the parties have therefore determined that it would be appropriate and in their mutual best interests to enter into this Option to Sell Agreement in order to evidence the rights of LESSOR and the obligations of LESSEE for the sale and purchase of said Equipment; and

WHEREAS, certain terms used herein without definition shall have the meanings ascribed thereto in the Lease Agreement, and this Option to Sell Agreement is made subject to the terms and conditions of said Lease Agreement, all of which are incorporated herein and by reference made a part hereof;

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and for other good and valuable consideration, the receipt and sufficiency whereof is hereby acknowledged, the parties agree as follows:

1. **Agreement to Purchase Equipment.** Subject to the terms and conditions set forth herein, LESSEE agrees to purchase the Equipment from LESSOR if LESSOR elects to sell such Equipment. If LESSOR desires that LESSEE purchase the Equipment prior to or upon expiration of the Lease Agreement, then LESSOR shall give written notice to LESSEE of such requirement. LESSEE shall have 180 days from the date of receipt of written notice to purchase equipment should LESSOR wish to sell.

2. **Purchase Price.** The price to be paid by LESSEE to LESSOR for such Equipment (the "Purchase Price") shall be Seven Thousand and no/100ths Dollars ($7,000.00) per unit. The Purchase Price shall be payable by the LESSEE's delivery of a check for the aggregate amount thereof to LESSOR at LESSOR's address set forth herein.

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EXHIBIT 6

of the AAA and the provisions of this Section 7. There shall be no discovery except as the arbitrator shall permit following determination by the arbitrator that the party seeking such discovery has a substantial demonstrable need. All other procedural matters shall be within the discretion of the arbitrator. In the event a party fails to comply with the procedures in any arbitration in any manner determined by the arbitrator, the arbitrator shall fix a reasonable period of time for compliance and, if the party fails to comply within such period, a remedy deemed just by the arbitrator, including, without limitation, an award of default, may be imposed.

8. **MISCELLANEOUS.** This Option to Sell Agreement shall be binding upon the parties hereto and their heirs, executors, administrators, successors and assigns. Wherever possible each provision of this Option to Sell Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision hereof shall be prohibited or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity without invalidating the remainder of such provision or remaining provisions of this Option to Sell Agreement. No delay or failure on the part of either party in the exercise of any right or remedy hereunder shall operate as a waiver thereof, nor as an acquiescence in any default, nor shall any single or partial exercise by either party of any right or remedy preclude any other right or remedy. This Option to Sell Agreement and the documents referred to herein constitutes the entire agreement between the parties concerning the subject matter hereof, and any other agreements or understandings of any nature with respect to such matters are hereby superseded and revoked. This Option to sell Agreement shall not be modified or amended except in writing signed by both parties. This Option to Sell Agreement may be executed and delivered in any number of counterparts, including facsimile counterparts, all of which when executed and delivered shall have the force and effect of an original. In construing this Option to Sell Agreement, feminine or neuter pronouns shall be substituted for those masculine in form and vice versa in any place where the context so requires, and plural terms shall be substituted for singular and singular for plural in any place where the context so requires. The headings in this Option to Sell Agreement are inserted for convenience only and are not a part of the Option to Sell Agreement.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

LESSEE: ETS Payphones, Inc.	LESSOR: FINANCIAL WORLD COMPANIES INC
By:	By:
Charles E. Edwards	
Charles E. Edwards	
CEO	President